

Water today, water tomorrow

Bulk supply pricing – a statement of our policy principles

About this document

This document sets out the principles we propose to use when making determinations on bulk supply agreements. We have powers under sections 40 and 40A of the Water Industry Act 1991 (as amended) to determine bulk supply prices and other contracted terms of bulk supply agreements.

A bulk supply is the supply of water, sewerage or water and sewerage services from one appointed water company to another. 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 the companies fail to reach agreement, they can ask us to make a decision (a 'determination') on the terms of the bulk supply agreement.

Our principles are intended to provide us with a clear basis on which to make decisions on individual agreements. They also provide our stakeholders with greater clarity on how we will reach our decisions. They are not intended to provide a methodology for bulk supply pricing.

In this document, we set out:

- our policy principles; and
- the information we need from relevant parties when making a determination on a bulk supply.

Contents

Foreword	3
1. Introduction	4
2. Our policy principles	7
3. Information requirements – bulk supply pricing determinations	13
Appendix 1: Relevant extracts from sections 40 and 40A of the Water Industry Act 1991 (as amended)	16

Foreword

The water and sewerage sectors have achieved much since privatisation in 1989. Since then, the companies we regulate have invested about £90 billion in services and infrastructure. This has delivered higher standards of service to customers, top quality drinking water and improved compliance with tough environmental standards. At the same time, our efficiency challenge means that customers' bills are a third lower than they would otherwise have been, while leakage has been reduced by more a third from its peak in the mid-1990s.

However, the world we live in is becoming increasingly uncertain. Future challenges, including climate change and population growth, could pose a real risk to the long-term security of essential water and sewerage services. To meet those challenges, we need to find new, smarter ways of working. We need to develop frameworks and policies that support our vision of delivering sustainable water.

So we have developed our policy principles for bulk supply pricing in line with our strategic goal of harnessing market forces to help us to achieve that vision. Bulk supplies are purchased by new entrants into the water and sewerage services market, so that they can supply services to their customers. Those new entrants provide a source of challenge to existing companies, driving efficiency, stimulating innovation and revealing the crucial information we need to make sustainable decisions. Our policy principles for bulk supply pricing will provide clarity, thus helping to reduce barriers to entry for new appointees.

The approach we are taking to bulk supply pricing determinations can also influence the development and usage of bulk transfers between existing suppliers. These can have implications on efficiency of investment and use of resources and make an important contribution to the achievement of our vision of sustainable water. And the development of policy principles in this area will help us to manage our own resources better.

We will keep our policies under review in response to further developments in the sectors, as well as changes in legislation and the wider regulatory framework. Most importantly, we will work to make sure that we act in the best interests of consumers, both now and in the future.

Regina Finn
Chief Executive

1. Introduction

1.1 Appointed companies

Under the Water Industry Act 1991 (WIA91), every part of England and Wales has a company that is licensed (or 'appointed') to provide water, sewerage or water and sewerage services to a specific geographic area.

Most customers receive these services from 21 existing appointed companies. These were appointed at privatisation in 1989, although some have subsequently merged.

Some customers receive their services from newly-appointed companies that have been licensed by us and which serve very small, local geographic areas. In a given area, usually no more than a single development in size, the new appointees replace the previous appointed company and take on all of their responsibilities.

All new companies must apply to us to be licensed to replace another appointed company in a specific area (a 'new appointment'). Appointed companies must also apply to us to change their licence if they wish to extend the area that they service (a 'variation').

New appointments and variations are a form of competition that allows some customers, under certain criteria, to choose a different supplier of services. As a result, they can deliver a number of potential benefits to customers, including:

- lower prices;
- improved service;
- a better range of products and services;
- environmental benefits; and
- customer choice.

1.2 Bulk supply agreements

Each appointed company must meet its legal obligations to provide services to its customers in its area of appointment. They can choose how best to do this. One possible method is to pay another appointed company to supply them with water, or a sewerage service, which they use to serve their customers. These are called 'bulk supplies'.

Bulk supplies include:

- an existing appointed company supplying water, sewerage or water and sewerage services to a new appointee; or
- an existing appointed company supplying water, sewerage or water and sewerage services to another existing appointed company.

The companies involved draw up a contract (a 'bulk supply agreement'). This sets out the terms and conditions for the bulk supply, including the price to be paid.

1.3 Our powers in relation to bulk supply agreements

When seeking to draw up a contract, the parties may fail to agree on:

- the terms of a proposed bulk supply agreement;
- how the terms of an existing agreement should be changed; or
- whether the terms of an existing agreement should be cancelled.

In these circumstances, one or both of the companies can ask us to determine the terms of the bulk supply. Under sections 40 and 40A of the WIA91, we have powers to determine the price (and other contractual terms) of actual or proposed bulk supply agreements, including those that involve:

- an existing appointed company providing a bulk supply to a new appointee that, in turn, serves a customer who uses more than a given amount of water (a 'large user');
- an existing appointed company providing bulk supply to a new appointee that, in turn, serves a new development, such as a new housing estate; and
- a bulk supply between existing appointed companies.

Our powers to determine bulk supply prices only apply if the matter is referred to us by one or more of the parties to the existing or proposed agreement. We must also be satisfied that agreement cannot be reached between the various companies. And before we make a determination, we must agree that the proposal, variation or termination of the agreement (whichever is applicable) will secure the efficient use of water resources or the efficient supply of water.

1.4 Policy principles for bulk supply pricing

Chapter 2 sets out the principles that we will use to guide our decisions on individual bulk supply agreements. We consider that there are a number of benefits from developing and publishing these principles. We discuss these in the next chapter.

2. Our policy principles

We should determine bulk supply prices so that those prices:

- reflect the costs reasonably associated with the provision of the relevant services;
- facilitate the efficient use of resources and effective competition within the water supply industry, where appropriate; and
- are consistent with the discharge of the relevant duties and obligations of the relevant supplier.

2.1 Our guidance

Bulk supply prices should reflect the costs reasonably associated with the provision of the relevant services.

What are the relevant services?

When identifying the cost of a bulk supply, we consider that the costs incurred should relate to the services being provided. Therefore, it is important to identify the relevant set of services that have been (or will be) provided under the bulk supply agreement. It is the cost of these services that will be assessed.

For example, bulk supply agreements do not involve the provision of retail services. So, 'retail' costs are not relevant to the assessment of a reasonable reflection of costs.

How should the costs reasonably associated with the provision of the relevant services be assessed?

In line with the provisions of sections 40 and 40A of the Water Industry Act 1991 (WIA91), both already incurred costs, and costs likely to be incurred in the future, can be considered as relevant. For example, already incurred costs can be particularly relevant if a bulk supply agreement is being changed or terminated. This is because investment decisions, potentially involving significant cost commitments, may have been taken based on the existing agreement.

When considering already incurred or likely to be incurred costs, it will be necessary to consider the level of costs reasonably associated with the provision of the relevant services.

In determining costs, a key question is whether (and to what extent) bulk supply determinations should use:

- the average cost of supplying other customers ('average cost'); or
- an assessment of the costs associated with a specific customer ('specific cost').

If a service is provided using a network, it may be genuinely difficult to distinguish between the costs associated with providing an individual customer with a service, and the costs of other services. When the provision of services involves the same network there may be:

- 'joint' costs;
- 'common' costs; or
- network benefits.

In such cases, we will typically consider practicability and proportionality when determining the extent to which we should try to reflect the costs of serving particular customer requirements. Consider the following examples.

- If a network has a large number of relatively small users, a common charging scheme that involves a significant degree of averaging can provide a practical and proportionate means of reflecting the costs of provision. This is despite the fact there may be some relevant differences in circumstances between particular customers that will not be closely reflected in the resulting charges.
- If there are fewer users, and the network interactions are more limited, the balance of arguments may be more in favour of a specific cost assessment.

The practicability and proportionality of different approaches to the assessment of cost will partly depend on the availability of information. When considering issues of practicability, it is important to recognise that the availability of information is likely to evolve over time. This means we may be able to change the way we assess costs in the future.

For example, in the energy sector, the level of sophistication and targeting of network charging mechanisms has evolved over time as information conditions have improved and new methodologies have been developed.

When we consider the extent to which an averaged or more specific approach should be used, we will also take account of the benefits of simplicity and transparency in charging arrangements. Simplicity and transparency are desirable, but they must be compared with the benefits of more sophisticated approaches. For example, transparency can help to reduce barriers to entry. However, it can also

hamper competition where it involves standardisation that limits scope for innovative contract developments.

Bulk supply prices should facilitate the efficient use of resources and effective competition within the water supply industry, where appropriate.

In our view, bulk supply pricing provides an important tool to:

- secure the efficient use of resources; and
- encourage effective competition within the water supply sector.

In order to do this, it is important that bulk supply prices reflect costs. Cost reflectivity is central to the provision of efficient economic signals – which feed into the assessments of potential competitors – and, more generally, for efficient resource use.

When determining bulk supply prices we will guard against ways in which price or other terms could prevent, restrict or distort competition. For example, the bulk supply price will be an important element in the costs of a new appointee, and could potentially be used by the existing appointed company to reduce the margins the new company can earn in competing with it.

Bulk supply prices should be consistent with the discharge of the relevant duties and obligations of the relevant supplier.

When we determine bulk supply terms, we will take account of the duties and obligations placed on the company providing the bulk service as a result of their appointment. For example, under section 41 of the WIA91 water undertakers have (under defined circumstances) a duty: **‘to provide a water main to be used for providing such supplies of water to premises in a particular locality in its area as... are sufficient for domestic purposes’**.

The onus would be on the supplier to alert us to any potential inconsistencies between the bulk supply – or particular terms of the bulk supply – with the discharge of their relevant duties and obligations. We will consider potential inconsistencies to ensure that the discharge of the relevant duties and obligations of the supplier is enabled in ways that do not unduly undermine our other bulk supply policy principles.

2.2 Information requirements – bulk supply pricing determinations

When we consider a bulk supply pricing determination, we are likely to require a number of different types of information. These are set out below. The time taken to

provide us with this information, and the quality of the information provided, will affect the time we take to determine the bulk supply terms.

The precise information requirements for a bulk supply pricing determination will vary depending on the facts of the case.

What services are to be provided?

We will want to establish early on in the determination process what services are to be provided under the terms of the bulk supply agreement. This will allow us to determine the costs reasonably associated with those services.

As a result, we will require the following types of information on the key characteristics of the service to be provided.

- The types of services to be provided under the agreement (for example, drinking water and sewerage services).
- Information on the quantities that the agreement provides for and, where relevant, supporting information on historic usage levels for different services.
- Any relevant characteristics related to the quantity of supply, including, for example, limits and conditions associated with maximum levels of usage over different time periods, and where different levels of reliability apply to different quantities.
- Supporting information on historic usage levels for different services, and, where relevant, details of the past contractual arrangements that provided for those usage levels. The appropriate level of detail for such data would depend on the nature of the services being provided. For example, if day-to-day reliability or availability is a key feature of the service being provided, then we would be likely to want to examine historic data on daily usage levels. This will allow us to establish the extent to which usage varies on a day-to-day basis. In this case, we would also be likely to want information about the source of the variability. Particularly the extent to which it arose as a result of either the varying demands of the customer or the varying availability from the supplier.
- Information on the quantities and quality of service provided to other customers in the area. This enables us to put both the quantitative and qualitative characteristics of the agreement into context.
- For each relevant characteristic, information on the quality of the service that would be provided under the agreement. For example, this may include information on the standard of treatment required and the reliability of the service (to the extent that this is not covered in the above points).
- Supporting information on the historic levels of quality provided where relevant (again for each of the different relevant quality characteristics that have been identified).

- Detail of other relevant characteristics of the service that the customer requires, such as special payment conditions, that are not covered by the above points.

In some cases, the parties may not agree on all the characteristics of the service. This will make it difficult to identify a single set of appropriate service characteristics. In such cases, it is important that those that have been agreed are clearly identified and supported by the appropriate information.

In cases where there is a difference of opinion about service characteristics, we will expect to receive information that sets out clearly:

- what the difference is;
- how it relates to the historic provision of the particular characteristic (where appropriate); and
- how other customers in the area are treated (or have been treated) in relation to that service characteristic.

2.3 How are services provided?

We will generally need information on how each of the relevant services has been (or is to be) provided. We will need details of the supply system that is used to provide each service, including:

- a description of the assets used to supply the customer;
- the extent to and ways in which this supply system is used to provide other customers;
- the extent to which there are particular characteristics of the supply system that affect the cost of providing the supply under the agreement; and
- whether providing the supply under the agreement is expected to give rise to significant additional or earlier capital expenditure in the future.

2.4 Relevant cost and charge level information

We expect the parties to the agreement to set out the level(s) they consider the bulk supply price(s) should be set at, and the basis upon which they consider such levels appropriate. This should include an explanation of how they arrived at these prices (having identified any relevant assumptions).

In addition, we will expect the parties to provide details of:

- previous charges that applied to the site(s) in question and, where possible, details of the basis on which those previous charges were calculated;
- how historic and proposed charges compare with the charge levels that are, and were historically, paid by other comparable customers nearby; and
- particular features of supply to the relevant site that have in the past (or may in the future) justify charge levels that are different from charges paid by otherwise similar customers nearby.

The type and detail of the cost information that we need will depend on the particular case. This includes the extent to which our assessment will be based on averaged or more site-specific costs.

3. Information requirements – bulk supply pricing determinations

When we consider a bulk supply pricing determination, we are likely to require a number of different types of information. These likely types of information are set out below. The time taken to provide us with this information and the quality of the information provided will affect the time taken to determine the bulk supply terms. The precise information requirements for a bulk supply pricing determination will vary depending on the facts of the case.

3.1 What services are to be provided?

We will want to establish early on in the determination process what services are to be provided under the terms of the bulk supply agreement. This will allow us to determine the costs reasonably associated with those services. As a result, we will require the following types of information on the key characteristics of the service to be provided.

- The types of services to be provided under the agreement (for example, drinking water and sewerage services).
- Information on the quantities that the agreement provides for, and – where relevant – supporting information on historic usage levels for different services.
- Any relevant characteristics related to the quantity of supply, including, for example, limits and conditions associated with maximum levels of usage over different time periods, and different levels of reliability apply to different quantities.
- Supporting information on historic usage levels for different services, and (where relevant) details of the past contractual arrangements that provided for those usage levels. The appropriate level of detail for such data would depend on the nature of the services being provided. For example, if day-to-day reliability or availability is a key feature of the service being provided, then we would be likely to want to examine historic data on daily usage levels. This will allow us to establish the extent to which usage varies on a day-to-day basis. In such a context, we would also be likely to want information to allow us to understand the source of such variability. In particular, we would want to understand the extent to which it arose as a result of the varying demands of the customer or varying availability from the supplier.
- Information on the quantities and the quality of service provided to other customers in the area. This enables us to put both the quantitative and qualitative characteristics of the agreement into context.

- Information on the quality of the service that the agreement is intended to provide for, in relation to each of the characteristics that are relevant. For example, this may include information on the standard of treatment required and the reliability of the service (to the extent that this is not covered in the above points).
- Supporting information on the historic levels of quality provided where relevant (again for each of the different relevant quality characteristics that have been identified).
- Detail of other relevant characteristics of the service that the customer requires, such as special payment conditions, that are not covered by the above points. In some cases, the parties may not agree the definition of service characteristics. This will make it difficult to identify a single set of appropriate service characteristics. In such cases, it is important that those that have been agreed are clearly identified and supported by the appropriate information. In cases where there is a difference of opinion about service characteristics, we would expect to receive information that sets out clearly:
 - what the difference is;
 - how it relates to the historic provision of the particular characteristic (where appropriate); and
 - how other customers in the area are treated (or have been treated) in relation to that service characteristic.

3.2 How are services provided?

We will generally need information on how each of the relevant services has been (or is to be) provided. We would want details of the supply system that is used to provide each service, including:

- a description of the assets used to supply the customer;
- the extent to and ways in which the supply system is used to provide other customers in addition to the provision of services under the agreement;
- the extent to which there are particular characteristics of the supply system that affect the cost of providing the supply under the agreement; and
- whether providing the supply under the agreement is expected to give rise to significant additional and/or advancement of capital expenditure going forward.

3.3 Relevant cost and charge level information

We expect the parties to the agreement to set out what level(s) they consider the bulk supply price(s) should be set at, and the basis upon which they consider such

levels appropriate. This should include a breakdown of how they arrived at these prices (having identified any relevant assumptions).

In addition, we would expect to consider information on:

- previous charges that applied in relation to the site(s) in question and, where possible details of the basis upon which those previous charges were arrived at;
- details of how historic and proposed charges compare with the charge levels that are, and were historically, paid by other comparable customers in the relevant locality; and
- details of particular features of supply to the relevant site that have in the past, or may going forward, justify charge levels that differ from those faced by other customers in the relevant locality that are otherwise similar.

The type and detail of the cost information that we need will depend on the particular case. The extent to which our assessment will be based on averaged or more site specific costs will clearly affect this.

Appendix 1: Relevant extracts from sections 40 and 40A of the Water Industry Act 1991 (as amended)

When do sections 40 and 40A apply?

Section 40(1) of the WIA91 (as amended) states that:

Where, on the application of any qualifying person

- a) it appears to the Authority that it is necessary or expedient for the purposes of securing the efficient use of water resources, or the efficient supply of water, that the water undertaker specified in the application (“the supplier”) should give a supply of water in bulk to the applicant, and**
- b) the Authority is satisfied that the giving and taking of such supply cannot be secured by agreement**

the Authority may by order require the supplier to give the applicant to take such a supply for such period and on such terms and conditions as may be provided in the order.

Section 40A(1) is very similar, but concerns situations where:

it appears to the Authority that it is necessary or expedient for the purposes of securing the efficient use of water resources, or the efficient supply of water, to vary the agreement or to terminate it.

What factors must Ofwat have regard to under section 40 and 40A?

Section 40(6) states that:

In exercising its functions under this section, the Authority shall have regard to the desirability of -

- a) facilitating effective competition within the water supply industry;**
- b) the supplier’s recovering the expenses of complying with its obligations by virtue of this section and securing a reasonable return on its capital;**
- c) the supplier’s being able to meet its existing obligations, and likely future obligations, to supply water without having to incur unreasonable expenditure in carrying out works;**
- d) not putting at risk the ability of the supplier to meet its existing obligations, or likely future obligations, to supply water.**

Section 40A(7) sets out the same list as shown above under s40(6), but - ahead of that list – includes the additional requirement that:

...the Authority shall have regard to the expenses incurred by the supplier in complying with its obligations under the bulk supply agreement...



Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699

Website: www.ofwat.gov.uk
Email: enquiries@ofwat.gsi.gov.uk
February 2011

© Crown copyright 2011

You may reuse this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/> or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU or email psi@nationalarchives.gsi.gov.uk.

This publication is also available on our website at www.ofwat.gov.uk. Any enquiries about this publication should be sent to the above address.