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Dear Mr Hopkins

Negotiating bulk supplies – A consultation on our guidance

We are pleased to comment on your proposed guidance on negotiating new bulk supplies.

We note your view that guidance is preferable to a model agreement, however, a model agreement offers the advantage of equity for customers of all companies compared to bespoke contract terms.

You refer to your guidance on bulk supply pricing from February 2011. I attach a further copy of our response to that consultation as the views we expressed at that time remain pertinent to the current consultation.

The guidance is useful in covering a range of issues that should be considered in negotiating a bulk supply contract, however, it omits detailed consideration of pricing structure.

Whilst recognising it is the responsibility of water companies to comply with the requirements of the Competition Act, in our view the document should include further consideration of how Ofwat would treat new bulk supply agreements at subsequent price reviews and in particular the time period companies may be expected to retain a gain share arising from the agreement. This would ensure an effective, transparent and equitable incentive mechanism.

The document refers to the need for the duration of agreements to be long enough to recover the cost of setting up the supply but does not consider how costs should be assessed when a supply is made available as a result of a reduction in demand arising from leakage reduction, metering or water efficiency or indeed a combination of supply and demand measures acting in concert and remote from the supply location compared to a singular scheme. In this case the determination of a long run marginal cost that might otherwise be used as a basis for a price negotiation may not be readily determined. Ofwat views on this area would be valuable.

It would also be helpful if the guidance gives further consideration to the matter of marginal and average costs and the extent to which agreements might be expected to reflect the direct cost of a new supply as well as a contribution to fixed costs to prevent cross subsidy between of customer groups and therefore what degree of disclosure of cost information is considered reasonable in order to effect an equitable negotiation.

The guidance should also consider the role of price precedents as benchmarks for a new bulk supply agreement and the manner in which access codes would affect them. We are reminded that the terms of a new agreement must in principle be available to all customers to prevent preferential treatment which may contravene competition law, even though a particular agreement relating to a specific supply location and arrangement may be offered as a special agreement.

Where a new supply is comparable to an existing transfer agreement it would be valuable to include guidance on the relevance of existing tariffs as a benchmark for the new price. Existing supply tariffs that have been in place for some years invariably reflect average costs rather than marginal costs, however those that pre-date privatisation might be less relevant to benchmark the new tariff than more recent tariffs. If these matters are not fully explored a new agreement might undermine the current principles applied to the setting of large user and other tariffs and thus competition law.

I hope these comments are helpful.

Yours sincerely



Mike Pocock
Physical Asset Strategy Manager