



Bulk Supply Pricing Consultation
Markets and Economics Division Business Support
Ofwat
Centre City Tower
7 Hill Street
Birmingham
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17th June 2010

Dear Sir,

Bulk Supply Pricing Consultation

Thank you for your letter of 5 March. We have commented on some general points around bulk supply pricing as well as on the specific principles in the consultation paper. Please can you take account of these views when finalising your policies in this area.

Overall

We agree that Ofwat should only intervene when the parties to a bulk supply, negotiating in good faith, have not reached agreement, and where Ofwat conclude that a bulk supply option is likely to result in an efficient use of water resources. We recognise however that when parties negotiate for bulk supplies, their expectations of how Ofwat might ultimately determine will influence their negotiating behaviours. Therefore, it is helpful for Ofwat to publish the principles it intends to use as this is likely to promote negotiated outcomes.

We agree also that if there were more bulk supplies, this might produce more cost effective options for addressing supply demand deficits and might also promote competition. We think it essential that if companies are to be incentivised to make more bulk supplies they must be assured that the price will be adequate to cover operating expenditures, capital maintenance expenditures and allow a reasonable return on capital. The price also needs to anticipate foreseeable enhancement expenditures.

To improve incentives for new bulk supplies, Ofwat should allow a company to retain the benefits of the higher income for a fixed period, say 5 years, before the benefits are shared with customers. This avoids the situation where a company who sells a bulk supply in year 4 of an AMP would only be able to retain the income for 2 years before price limits were re-determined, where another company selling a bulk supply in year 1 of an AMP period might retain

income for 5 years before prices were re-determined. We believe Ofwat needs to introduce a 5-year rolling mechanism into its price control methodology, similar to those it already operates for opex and capex outperformance retention, to equalise the incentives to sell bulk supplies across the 5-year price control period.

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

We think few would argue that bulk supply prices should be divorced from reasonable costs, so the key question is whether costs are measured as regional averages, or on a more specific level. In most cases, customers make common use of public water supply assets so it remains appropriate to price bulk supplies at regionally averaged tariff rates, perhaps with some adjustments to reflect genuine differences in service required by large users versus bulk supply customers. It would reflect that in most circumstances it is not possible to identify the costs imposed on the network by an individual bulk supply customer. This also preserves socially desirable cross subsidies present in today's averaged tariffs.

In relatively few cases, the costs imposed by a large customer may be more visible, such as where there are dedicated assets or the customer chooses a different level of service. In these cases, a site-specific price may be appropriate. In practical terms these cases are the same as special agreements and Ofwat should use the same criteria to judge whether a site-specific price is appropriate as it does when it considers if a special agreement price is justified.

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

We agree with the general principle that pricing should be used to increase economic efficiency. Our belief is that the best way to induce economic efficiency in consumption and production decisions is to set the volumetric rates for tariffs at their estimated long-run marginal cost of water. Were this to result in revenues that did not recover average accounting costs, the deficit can be made up by using a rising block tariff structure, or supplementary fixed charge. If the volumetric rate were likely to over recover revenue versus average accounting costs, the tariff could have a free tranche of water (e.g. negative fixed charge), or a falling block structure.

We think that bulk supply prices that reflected the long run marginal costs of water would provide efficient entry signals to competitors as well as reflecting the expected future costs of maintaining the water resources balance.

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

We agree with the general principle that water suppliers should alert Ofwat if they have reason to believe that the making of a bulk supply would jeopardise their ability to carry out their proper functions - for example ensuring sufficient water to meet demand for domestic purposes. We agree that it is then proper for Ofwat to consider these arguments in its determinations.

Yours faithfully



Guy Chalkley
Director of Finance