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Water industry stakeholders

18 January 2016

Dear stakeholders,

Clarification of the application of the PR14 water trading incentives to small appointed water companies and third parties

We intend to publish an update of the Price Review 2014 (PR14) Reconciliation Rulebook in mid-February 2016 and include in this update some additional clarifications on the operation of water trading incentives for the 18 largest appointed water companies¹ that are subject to full retail and wholesale price controls.

This letter summarises our proposed approach to these clarifications and seeks views on these matters by **close Wednesday 3 February 2016**. Please send any comments you have in relation to this letter to jon.ashley@ofwat.gsi.gov.uk.

We consulted extensively during 2012 and 2013 on the main aspects of the PR14 water trading incentives ahead of their inclusion in the December 2014 final determinations. We also consulted on the operation of the incentives (including the application of adjustments for inflation, the time value of money and the treatment of taxation) through the PR14 Reconciliation Rulebook consultation in March 2015.

In the PR14 Methodology Statement (July 2013) we explained that the water trading incentives only apply to the relevant price regulated water companies. We stated that we would address whether and how the water trading incentives apply to new appointees at a later date and presented some proposals at a workshop for small companies in November 2013. We also explained that the water trading incentives would not apply to third parties who are able to retain all the profits for water trading as they are not subject to our price control regulation.

We are clarifying the application of the water trading incentives to the eight instances set out in the table below which were not covered in the PR14 Methodology Statement or the July 2015 version of the Reconciliation Rulebook. We have provided a summary explanation of our reasons for our preferred approach.

¹ By appointed water companies we mean, for these purposes, companies holding appointments as water undertakers.

The distinction between a large appointed water company and a small appointed water company in relation to the water trading incentives is based primarily on the difference in price control regulation, which is proportionate to the relative size of the businesses. Large appointed water companies are subject to detailed price control regulation (including separate retail and wholesale price controls) but small appointed water companies are currently subject to relative price controls or, in the case of Cholderton and District Water Company, a simplified revenue control.

| Description of transaction and whether an incentive applies | Reason for proposed approach to whether a water trading incentive applies |
|---|--|
| <p>1: An export from a large appointed water company to a small appointed water company</p> <p>NO EXPORT INCENTIVE APPLIES</p> | <p>Almost all new water appointee sites are served by a bulk supply export from the local large appointed water company². The motivation for the export incentive was to overcome the artificial barriers to water trading between large appointed companies. We do not have evidence of artificial barriers to trading that have prevented new appointee sites from receiving supplies. Therefore, at this stage we are not proposing the extension of export incentives to these circumstances. We propose that the export incentive does not apply to a large appointed water company exporting water to a small appointed water company (as defined in footnote 3³).</p> |
| <p>2: Import to a small appointed water company from a large appointed water company</p> <p>NO IMPORT INCENTIVE APPLIES</p> | <p>Almost all new appointee sites are served by a bulk supply import to the small appointed water company. As in (1) above we do not have evidence of artificial barriers to these arrangements and in any case the small appointed companies typically have incentives for efficiency created by their relative price controls. We therefore propose that the import incentive does not apply to a small appointed water company importing water from a large appointed water company.</p> |
| <p>3: Import to a large appointed water company from a small appointed water company</p> <p>IMPORT INCENTIVE APPLIES⁴</p> | <p>Large appointed water companies are eligible for an import incentive for an import of water from another large appointed water company. We consider our water trading incentives would unintentionally bias the market in favour of large appointed water companies if the import incentive did not also apply to imports from small appointed water companies to large appointed water companies. We propose that a large appointed water company is eligible for an import incentive for an import of water from a small appointed water company.</p> |

² 41 out of 42 new appointee sites are served by a water export from the local large appointed water company. The remaining water appointee site self-supplies itself with water.

³ By small appointed water companies we mean water undertakers that, because of their size, are not subject to full price controls. This currently means Cholderton and District Water Company and five new appointees: Albion Water, Independent Water Networks, Peel Water Networks, SSE Water and Veolia Water Projects.

⁴ The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

| Description of transaction and whether an incentive applies | Reason for proposed approach to whether a water trading incentive applies |
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| <p>4: Export from a small appointed water company to a large appointed water company</p> <p>NO EXPORT INCENTIVE APPLIES</p> | <p>As noted above small appointed water companies are not subject to our full price control regulation and are typically able to retain all the profits from an export to a large appointed water company. The introduction of export incentives would also add unnecessary complexity to new appointees' simplified price controls. As a result we propose that the export incentive does not apply to an export from a small appointed water company to a large appointed water company.</p> |
| <p>5: Import to a small appointed water company from a third party</p> <p>NO IMPORT INCENTIVE APPLIES</p> | <p>We do not have evidence of artificial barriers to small appointed water companies importing water from third parties. In any case the small appointed companies typically have incentives for efficiency created by their relative price controls. We therefore propose that the import incentive does not apply to a small appointed water company importing water from a third party.</p> |
| <p>6: Export from a small appointed water company to a third party</p> <p>NO EXPORT INCENTIVE APPLIES</p> | <p>Small appointed water companies are not subject to our full price control regulation and are typically able to retain all the profits from an export to a third party. The introduction of export incentives would also add unnecessary complexity to new appointees' simplified price controls. As a result we propose that the export incentive does not apply to an export from a small appointed water company to a third party.</p> |
| <p>7: Import to a large appointed water company from a third party</p> <p>IMPORT INCENTIVE APPLIES⁵</p> | <p>Large appointed water companies are eligible for an import incentive for an import of water from another large appointed water company. We consider our water trading incentives would unintentionally bias the market in favour of large appointed water companies if the import incentive did not also apply to imports from third parties to large appointed water companies. We propose that a large appointed water company is eligible for an import incentive for an import of water from a third party.</p> |

⁵ The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

| Description of transaction and whether an incentive applies | Reason for proposed approach to whether a water trading incentive applies |
|---|--|
| 8: Export from a large appointed water company to a third party EXPORT INCENTIVE APPLIES ONLY IN SPECIFIC CIRCUMSTANCES | If an export from a large appointed water company to a third party is not a regulated activity then the appointed company can keep all the profits from such an export subject to compliance with our transfer pricing rules. We therefore propose that the export incentive does not apply in these circumstances. If an export from a large appointed water company to a third party is a regulated activity <u>and</u> the sale results in a genuine water trading activity – such as the sale of water to an intermediary that then trades the water on outside of the appointee’s authorised area - then we propose that the water trading incentive would apply ⁶ . |

We welcome your comments on the proposed clarifications by the deadline set out above. We will consider your comments carefully before finalising our approach in the updated PR14 Reconciliation Rulebook in mid-February 2016.

Yours faithfully

Andrew Walker
Director

⁶ The water company will have to show that its export complies with an Ofwat-approved trading and procurement code for an export incentive to be paid at PR19.