RAPID – Water Trading Incentives and the Regulatory System – a proposal

Northumbrian note on the interaction of Bulk Supply income with the Price Control and a possible replacement for the Ofwat water trading incentive

This is a short discussion note for consideration by the RAPID working group on bulk supply charging. We welcome all feedback and comments.

1 The Disincentive to Trade: Regulatory Capture of Bulk Supply Income

RAG 4.08 allocates income from bulk supplies (Appointee to Appointee) as Third Party, not governed by price control, Wholesale Appointed:

RAG 4.08 – Appendix 1 (Income categorisation)

Income categorisation

	Retail appointed	Wholesale appointed		Non-appointed
		Income governed by price control	Income not governed by price control	
Principal services	Retail tariff income (for households and non-households) from water, foul sewage, surface water and highway drainage, trade effluent services and special agreements (including potable water, foul and trade effluent). Income from providing developer information and the administration of new connections (eg dealing with s45 connection charges). Income from meter reading commission.	Wholesale tariff income (for households and non-households) from water, foul sewage, surface water and highway drainage, trade effluent services, including special agreements. Electricity generation from appointed assets Developer contributions[1]; • Infrastructure charges • Requisition charges • s45 connection charges • s104 sewer adoption fees (based on 2.5% of the construction cost) • s185 diversions	Management of protected land Recreational use of protected land eg • Rambling • Forestry Rental income from appointed assets eg • mobile telephone masts on water towers, • wind turbines and solar panels on land at treatment works.	Non water/ wastewater services eg; • Billing commission • Garage services • Rental income from non-appointed properties • Property searches • Introducer revenue from plumbing and drainage insurance Tankered waste; haulage, reception and treatment.
Third party services		Non-potable water (which are not a bulk supply) Rechargeable works; - Fluoridation - Fire hydrant maintenance - Fire hydrant installation - Charges for repair of damage to company assets by another party - Charges for building over company assets - Charges for installation of a meter on an unmetered supply (non-household) - Fee for trade effluent consent revision - "Non-primary" charges to retailers under WSSL regime - Provision of plan information of underground infrastructure - Charges for flow and pressure testing of a customer supply - Meter testing - Relocation of a household meter - Installation of a meter with a data logger to a previously unmeasured premises	Excluded charges; - Bulk supplies - Stand pipes and water tanks - Water cleansing - Charges for reception and disposal of waste - Unmeasured cattle troughs - Unmeasured building water supplies - Unmeasured supplies by water tankers - Unmeasured farm taps - Reservoir operating agreements - Unmeasured supply hereditaments - Diversions (non s185)	Rechargeable work where the appointee is **not** a statutory supplier. Use of land for water supply beyond duties imposed by WIA91 eg • Water skiing/sailing, • Fishing, • Bird watching permits, • Restaurants/ visitor centres.

This means that income from new bulk supplies is not captured in the single till revenue control allowance set at each review. So, an Appointee can retain the profits from a new bulk supply in-period (third party costs are also excluded).

<u>However</u>, at the end of the period, the Periodic Review business plan tables capture forecasts of bulk supply income that will include this new bulk supply. Third party income is a deduction made from the building blocks revenue requirement when setting the control. In this way, the income relating to bulk supplies is captured within the revenue control from the start of the next control period.

Extract from Tables WR3 & WN3 of the PR19 Business Plan Tables

C	Wholesale water resources ~ non-price control income (third party services)
14	Bulk supplies ~ contract not qualifying for water trading incentives (signed before 1 April 2020) ~ water resources
15	Bulk supplies ~ contract qualifying for water trading incentives (to be signed on or after 1 April 2020) ~ water resources

Thus the profit incentive to export depends upon:

- The number of years between the income and the start of the next control period. This disincentivises bulk supplies later in the control period.
- If the Appointee forecasts future bulk supplies (that it is currently negotiating for example), then the profits are captured immediately. This further disincentivises the creation of bulk supplies around the time of the price control ending/starting.

The speed of this regulatory capture in relation to what can be long terms contracts can be seen as a disincentive for companies to expend resources and time in investigating and negotiating bulk trades.

2 Ofwat Water Trading Incentive

The Ofwat water trading incentive is designed to offset the revenue capture disincentive and aims to share bulk supply profits 50:50 between the company exporting and its customers.

There are two issues that undermine the power of this incentive:

1. Companies only find out if they are accepted for the incentive years AFTER the trade has been made. This can be up to 5 years later and the decision is made during a complex and busy review period.
2. The conditions for acceptance have a degree of regulatory subjectivity – the trading and procurement code guidance sets out a series of tests for a trade to qualify.

One solution could be for companies to agree upfront with Ofwat that a trade 'pre-qualifies', which would give them confidence over the incentive being forthcoming.

3 Alternative ways of Profit Sharing for Bulk Supplies

Instead of disincentivising bulk supplies by capturing the profits then trying to reverse it with a complex and uncertain water trading model, we should consider if there is a simpler way to directly incentivise bulk trading without requiring complex contradictory regulatory intervention. Ideally, this would be closer to a commercial market priced transaction as it would remove much of the regulatory impact from the negotiation.

This would allow the exporter to be more certain in advance what the retained profits of the trade would be. If there is uncertainty or an immediate capture of profits, the exporter may be inclined to charge more, thus making the trade less likely.

Option 1 Exclude the bulk supply income from the price control in perpetuity or for a full 5 year period

One very powerful incentive would be to remove income from bulk supplies from the price control in the Periodic Review. It could still be part of the Appointed business in legal terms, but just excluded in the price control calculations.

If this were felt that it was important that customers should share in the profits from trading, the income could be excluded from the bulk supplies for one Periodic Review, then captured in the next. This could be simply included in the PR24 Business Plan Table by distinguishing between trades that

started pre and post 2020. The most recent (2020-25) trades would be excluded from the price control (recording them but classifying them as non price control). Trades before 2020 would be captured in the price control.

In the next Periodic Review (PR29), the cut off date would move 5 years forwards (2025) as so the pre 2025 trades would be captured. Thus, the >5 years profits retention would be a significant incentive, with a relatively simple adjustment to the business plan tables.

Option 2 Use a simpler and more automatic profit sharing mechanism

The 'land disposals' profit sharing mechanism is used to share the profits from activities that use Appointed assets, but are discretionary, therefore require a profit to be retained by the Appointee as an incentive. The profits are shared 50:50 between Appointee and customers retrospectively at the end of each control period. The mechanism is well understood and applies to many activities that use Appointed assets.

The sharing mechanism ensures customers are rewarded for sharing the assets they have paid for and, by applying in retrospect, it does not require forecasting (there is an assumed value of zero when setting the controls).

If we applied this approach to bulk supplies, there would need to be changes to the RAGs and Business Plan tables for this to apply from 2025 onwards. It would be possible to apply this approach to new trades post 2020 onwards if more urgency was required.

General discussion points:

1. What approach to bulk supplies best promotes market-type transactions and efficient trades for customers in the long term?
2. Do Appointees need an incentive to export, or is it enough for it just to be a duty that they must comply with?
3. How much of an incentive do Appointees require to prepare and negotiate a bulk supply export?
4. Does it matter if the incentive is uncertain at the time of the trade?
5. Should sharing be time limited or for the whole contract?
6. Is a 50:50 share appropriate?

Northumbrian Water
April 2021