Northumbrian Water response to
Ofwat: Water 2020: Our Regulatory Approach, May 2016

Focusing on current and future customers
Q1 What are your views on our preferred approach to long-term commitments?

We support the preferred approach to long-term commitments – that companies should provide long-term aspirations for all their PCs at PR19 and be transparent about these with their customers and other stakeholders.

We believe this strikes the right balance between the desire to place performance in a longer term context, but recognising that customer priorities can change over time.

Moving beyond waste
Q1 Do you agree that sludge holding tanks with only passive thickening should be network plus assets?

We are concerned that the boundary between network plus and sludge may be being drawn up in an impractical way. Given the aim is for the sludge service to be fully contestable, it would be better to define the boundary as being the point at which the raw sludge is collectable by a third party (i.e. bioresources company). If this is not done, then any bioresources company will always be required to pay for using incumbent 'sludge assets' that they could not have provided themselves.

We agree that sludge holding tanks should be network plus assets – they are invariably integrated into the sewage treatment process and their use is unavoidable for a bioresources company.

Q2 a) Do you agree that sludge liquor treatment costs should be charged on the basis of a modified Mogden formula which includes a factor for ammonia concentration?
Q2 b) Do you agree that these liquor treatment charges should be calculated on a company average basis, as they are currently for trade effluent charges?

We do agree that, wherever possible, a company should charge for liquor treatment at a sewage treatment works in the same way it would charge for any other sewage received.

This charging may or may not include a factor for ammonia concentration – the liquor should be charged in the same way as any other sewage waste. Thus, this may depend upon whether the local works has an ammonia consent for example.

Northumbrian has no ammonia charging in its Mogden formula for standard trade effluent, so, for a level playing field, it should not charge for ammonia in returned liquors.

Q3 Do you agree that tonnes of dry solids should be used as the units on which to set the average revenue control for sludge?

We agree, tonnes of dry solids (tds) is the most reliable measure of the quantity of sludge. It is important to recognise that, for sludge transportation, tds is not relevant, as this is a cost driven by volumes.

We also agree that population equivalent data is important to collect as a cross check against this.

The units for setting the average revenue control should be as similar as possible to those used to carry out the cost assessment (particularly if it is a unit cost assessment). If this is not the case this could result in a company that was classed as 'efficient' charging more to customers than one that was classed as inefficient.

Tackling water scarcity
Q1 On our judgement, demand and utilisation risks relating to bilateral market entry should be allocated to incumbent water companies rather than customers, subject to our policy to protect the pre-2020 RCV. Do you agree that the water resources price control framework should differentiate between utilisation risks relating to market-wide demand and utilisation risk relating to bilateral market entry?

We do agree that there needs to be differentiation between utilisation risks relating to market-wide demand and utilisation risk relating to bilateral market entry.

Many companies propose demand side measures as part of their WRMP schemes. These, if successful, can reduce market demand, and companies must not be penalised for delivering such schemes. Our response to Q2 below gives further reasons why demand and utilisation risks for companies should be limited to bilateral market entry.

Q2 Do you agree that the price control arrangements for increases in water resources capacity should, at least in some circumstances, expose an incumbent water company to some degree of market-wide demand risk? If so, what circumstances?

We do not agree that increases in water resources capacity should be exposed to market-wide demand risk. Such an approach would create a perverse incentive for a company, once a new resource has been built, to encourage demand to increase to avoid the risk of under recovery of the investment. This would undermine the incentives for water efficiency projects and the rationale of a revenue control rather than a price cap.

We draw Ofwat's attention to the statement in Appendix 3, page 19:

It was suggested in the responses that a total revenue control approach should be retained to avoid a situation where water companies have a profit incentive to increase the volume of water delivered to customers, which might lead to undue water abstraction. ***We note that under our proposed form of control, the adjustment mechanism is limited to bilateral market entry and does not expose the incumbent to wider volume risk, and therefore the incentives in regard to water volumes will be similar.***

This statement appears to contradict the proposal in the question under which a profit motive would be created to increase the volume of water delivered to customers up to the capacity of the new resource or the original forecast demand level.

Many larger scale water resource projects generate excess capacity for a period of time before longer term demand increases use up that capacity. This does not mean these schemes are economically wasteful – on a whole life costing basis (as per the WRMP 20-30 year horizon), these schemes may well be the most efficient ones available. However, a short term (5 year) analysis at Periodic Reviews may penalise companies for considering larger scale assets that deliver efficiently over multiple periods compared to smaller ones that are more expensive yet easier to vary over a 5 year period.

There appears to be an underlying assumption that greater incentives will improve the quality of demand forecasting. We do not believe this to be true – demand forecasting is inherently uncertain.

Network plus scope of control
Q1 Which of the options described in Section 7.3.5 (and/or which other options) should be used to treat developer services in the network plus total revenues?
Please explain your reasoning. Please identify which services you think should fall within the generic term 'developer services' in the context of your answer.

We support the Option to:
Exclude all developer services from the network plus price controls and rely on competition in self-lay, competition law and new charging rules.

In our view, the new charging rules and the challenge of self-lay and competition law are sufficient to ensure new development is self-financing and cost reflective. We believe, with a reasonable level of charging guidance to ensure consistency, companies should be able to demonstrate that their charges are cost reflective.

In this way, with both development income and costs outside of the revenue control, companies are indifferent to the scale of development, and the income and costs vary in proportion. There is no risk of cross subsidy to or from the wholesale business.

We agree with the concern expressed by Wessex that the current arrangements create a disincentive for development for water companies. Under the present arrangements, increases in development generate income that is absorbed into a fixed revenue control, yet the associated increase in costs are shared between company and customers under the totex incentive regime.

Q2 Are there any other wholesale activities that should be excluded from the scope of the network plus price controls? If so, what are they and what problems would be resolved by excluding them?

There is already a degree of exclusion of third party income and costs, but we wonder if this could be made more explicit for PR19. As we understand it, third party services should be self-financing and cost reflective, so there is a strong similarity to the new development points above.

This would also mean there was no need for any mechanism to handle variances between FD and Actual and no incentives for companies to increase or decrease the level of third party activity.

Q3 Are there any costs that require clarification as to whether or not they should fall within the network plus price controls?

It is important that boundary between the network plus controls and the two new price controls (water resources and sludge) is clearly defined and that costs are allocated accurately and consistently. We believe this is best defined through the regulatory accounting guidelines, to allow for flexibility and transparency.