



Department  
for Environment  
Food & Rural Affairs

# **Water industry: Guidance to Ofwat for water bulk supply and discharge charges.**

**April 2018**



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## Contents

Introduction .....	1
Definitions and geographical extent .....	3
About this Guidance .....	3
Guiding principles .....	4
Existing guiding principles .....	4
Additional guiding principles for bulk supply and discharge charging rules .....	4
Conclusion .....	8

# Introduction

This guidance covers the rules which Ofwat, the independent economic regulator for the water sector, may set, through their [Charging Rules](#) and any other relevant [document](#), about bulk supply or bulk discharge charges. This follows the overarching statement of charging policy and principles in the [Charging Guidance to Ofwat](#)<sup>1</sup> published by the government in January 2016. This guidance is issued under sections 40I and 110J of the Water Industry Act 1991 (“WIA91”) and Ofwat must have regard to it when making Charging Rules that will apply to water companies that are wholly or mainly in England<sup>2</sup>.

In developing the high level principles contained in our January 2016 guidance, government consulted extensively with interested parties through technical Task and Finish Groups. By working with industry to understand the issues faced under the current regime, it has been the intention of government to issue guidance that will enable Ofwat to improve the bulk supply and discharge regime to meet the needs of bill payers, developers and communities as well as [long term government objectives](#) fairly and equitably. Since January 2016, the non-household retail market has opened for competition in April 2017 and some [evidence](#) highlighted charging as a potential area of concern to create an even playing field between incumbents and [inset appointees or New Appointments and Variations \(NAVs\)](#).

The government has also published its [strategic priorities and objectives](#) for Ofwat where it set out its expectations for the water sector to play its part through pace, innovation, responsiveness and streamlined processes to help achieve our ambition in reducing the long-term risk to water supply resilience from drought and other factors, including through new supply solutions, demand management and increased water trading.

This guidance has been developed in consultation with Ofwat, the Environment Agency, the Drinking water Inspectorate, Welsh Government and the Consumer Council for Water.

The term bulk supply refers to two different types of agreements and charges: A) it covers agreements for the supply of bulk water between incumbent water companies (these are often referred to as water trades); B) it covers bulk agreements between incumbent water companies and New Appointed Variations (NAVs.). These cover either the supply of bulk water, waste water discharge or, in the majority of cases, both services. These are discussed separately in this guidance.

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<sup>1</sup>[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/496044/charging-guidance-ofwat-2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496044/charging-guidance-ofwat-2016.pdf)

<sup>2</sup> Separate guidance will be issued by the Welsh government in relation to undertakers operating wholly or mainly in Wales.

## **A) Incumbent to incumbent water bulk supplies**

Large-scale transfers of water between companies and regions may offer the best value option to address the potential gap between the supply and demand of water resources. It is the practicality of these large water transfers from water surplus to water stressed areas, and the technical, environmental, policy & regulatory, financial and collaborative challenges this solution poses that need to be considered as part of our package of measures to improve long term resilience.

These changes will help the sector better realise trading potential and deliver economic and environmental benefits, by providing alternative sources of supply that may have lower costs or lower environmental impact.

Ofwat has already established a [Trading and Procurement Code](#), which includes a sustainability clause, to mitigate against possible environmental risks of trading. It also sets out the principles and assessment criteria that companies will follow when assessing proposed water trades with other appointed companies or third parties. It can include how the companies will communicate with potential trade partners and some of the terms of trading with the companies and ensures that companies are not trading in order to game the trading incentives, and are engaging in trades that are environmentally and economically beneficial. The codes also work to make sure that companies assess water trading options fairly and on an equal footing to their own water resource schemes. In February 2018, Ofwat consulted on its [guidance for trading and procurement codes](#) to reflect the latest market and regulatory developments.

## **B) Incumbent to NAVs bulk supply and discharge**

NAV's often depend on nearby incumbents for their bulk water and waste water discharge. As a result incumbents may have both the ability and incentives to place NAV's in an adverse position when competing for new development services by setting relatively high charges.

In May 2017, Ofwat commissioned [work](#) to:

- investigate how the NAV's market is working;
- consider the extent to which any factors currently act to prevent, distort or restrict effective competition; and
- set out options that we might consider to address issues identified.

This was prompted by complaints from NAV's about the impediments they faced in providing services to developers and end-customers, creating an unlevel playing field. An important factor was the incumbent water and wastewater companies' bulk charges.

The analysis of this independent work confirmed the importance of bulk charges for the supply of water and waste water discharge as a factor affecting NAV's' ability to compete to provide services related to new developments.

## Definitions and geographical extent

This Charging Guidance applies in relation to undertakers whose areas are wholly or mainly in England<sup>3</sup>. The Welsh government has the same powers in relation to undertakers wholly or mainly in Wales. Ofwat is the independent economic regulator and we make reference to Ofwat as such in this publication. References to “the government” are to the UK government.

We refer to “undertakers” in this publication instead of water and sewerage companies (WaSCs) and water companies (WoCs). This terminology is consistent with that used in WIA91 and the Water Act 2014 (“WA14”).

## About this Guidance

This guidance is issued to Ofwat and supplements guidance under section 144ZE of WIA91, as inserted by section 38 of WA14: General guidance on charges. Ofwat must have regard to any guidance issued under sections 40I and 110J of WIA91 by the Secretary of State when making *Charges Rules* that apply in areas that are wholly or mainly in England.

This guidance covers the principles to be applied by Ofwat in determining the provisions of rules under section 40E in relation to charges imposed by a water undertaker under a bulk supply and discharge agreement with another incumbent and/or NAVs.

Bulk discharge agreements are agreements between sewerage undertakers to make a main connection into one of the undertakers’ sewerage systems. These agreements are referred to as ‘sewerage main connection agreements’ in the Act and are analogous to a bulk supply agreement for water.

Section 9 inserts section 110F into the Water Industry Act 1991. Ofwat will have the power to make charging rules for sewerage main connection agreements and Ministers have powers to issue guidance to Ofwat under section 110J of the Act on the content of those charging rules. Under section 144ZE of the Act, Ministers also have powers to give guidance to Ofwat on the principles to be applied by Ofwat in determining these charging rules.

Ofwat’s charging rules will be subject to public consultation. The Minister<sup>4</sup> has a power to direct Ofwat not to issue the rules, for example, if he or she considers that the rules are not

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<sup>3</sup> Sections 40I and 110J of the Water Industry Act 1991.

<sup>4</sup> Welsh Ministers have the same powers in relation to undertakers wholly or mainly in Wales and will issue separate guidance.

consistent with the **government's guidance**. Where the government issues revised guidance, the Act requires that Ofwat should review and, if necessary, revise the relevant charging rules.

In producing charging rules, Ofwat must prepare a draft of any proposed rules and consult relevant persons (for example the **Environment Agency or Natural Resources Wales and Drinking Water Inspectorate**) before the rules come into effect. This means that these persons will have the opportunity to feed into the process at the outset in respect of all bulk supply and discharge agreements.

## Guiding principles

### Existing guiding principles

The Government has published four overarching **principles** for charging in respect of water and wastewater services. Each of these has equal weight and Ofwat must have regard to these in determining bulk supply and discharge Charging Rules. These are:

- Stable and predictable charges.
- Transparent and customer focused charging.
- Fairness and affordability (including to existing and new consumer customers).
- Environmental protection.

The government recognises that in practice, trade-offs will need to be made between these principles to reach the appropriate balance, such as between simple to apply charging formulae and more complex, but arguably administratively expensive detailed charges calculations.

### Additional guiding principles for bulk supply and discharge charging rules

#### 1. Environmental protection and enhancement:

We want to be the first generation to leave the environment in a better condition than we inherited it and our vision is set out in the [25 year environment plan](#). This includes ensuring a **sustainable and resilient** water sector for the long-term and promoting a good standard of environmental amenity for all existing and future occupants of the land and buildings. Ofwat should take account of the government's vision in setting charging rules and should ensure that companies have the right incentives to consider and take into account the environmental costs..

Incumbent water companies have statutory environmental duties to prevent them from entering into water bulk supply and discharge agreements that would damage the environment. This includes a duty under the regulations transposing the [Water Framework Directive](#) to have regard to river basin management plans when deciding whether to enter into water bulk supply and discharge agreements. River basin management plans set out the environmental objectives for the water bodies within the river basin district and how they will be achieved.

Ofwat should set charging rules that allow for relevant costs to be adequately reflected in order to provide incentives for efficient resource use and innovative solutions that are **sustainable over the longer term**.

Charging rules, where appropriate, should incentivise **environmentally friendly solutions**. Costs could include, but are not limited to, building / maintaining infrastructure, treating water, work to prevent or repair any **environmental damage**, work to enhance the environment, work required to comply with relevant legislation and any consequential costs.

## **2. Resilience to extreme events including drought:**

Where appropriate, Ofwat should aim to set charging rule principles that incentivise the water industry to develop a **resilience standard** to underpin guarantees of reliability in drought and extreme weather events of bulk water transfers between incumbents.

Where appropriate, Ofwat should set charging rules that provide incentives for **efficient resource use** to encourage **collaboration between neighbouring companies**. Regional or zonal charging may also inform undertakers' decisions and encourage the more efficient use of resource.

Ofwat should set charging rules that will encourage transparency and **collaboration** between suppliers to support the **consistency of approach to charges and sustainable development**. This should support planning for capacity requirements for strategic and/or large trades.

Costs of providing or reinforcing infrastructure can depend on the decisions made by the undertaker in respect to **location of the site and in respect to efficient resource use**. Ofwat should set charging rule principles that are consistent with aims to encourage incumbents to undertake **appropriate, timely and no regret investment decisions** ahead of future need in such a way as to **improve resilience and minimise the overall costs of infrastructure provision** that fall to current and future bill payers. Such investment would involve **collaboration and partnership** working with local planning authorities and other public bodies, and awareness of, and appropriate participation with the development of, local plans.

Ofwat should consider how best to support transfers of water between areas of future surplus and deficit with sufficient flexibility to deal with **uncertainties** in future drought impacts.



### 3. Drinking water quality:

This section sets out existing Ofwat duties.

Ofwat takes into account regulation 15 of the Water Supply (**Water Quality**) Regulations 2016 (“the 2016 Regulations”) and section 68 of WIA91 when making a determination. The legislation governing drinking water quality and the Drinking Water Inspectorate is clear about the legal obligations and requirements associated with water supply. Incumbents are legally responsible for ultimate supply to the customer and are obliged to not knowingly plan to supply water in the future of a lesser quality than they supply today, even if this quality is still within drinking water standards. As well as pollutants, such as pesticides, this also applies to other characteristics of the water, such as whether it is soft or hard, turbidity and iron discolouration.

Ofwat has a duty to encourage companies to carry out a transparent option appraisal to determine whether to take a bulk supply or not. As such, Ofwat would not force incumbents to take supply from another party as the receiving incumbent will always bear the responsibility of **water quality and acceptability** as set out in regulation 15 of the 2016 Regulations.

It is important that companies’ costs related to meeting **water quality standards** are accounted for in the principles companies follow in their charging structure.

### 4. Consumer protection:

Where this neither conflicts with competition law nor with other guidance related to NAVs and new entrants, Ofwat should require companies’ charges to reflect the costs arising from any bulk supply agreement, so that there is **no cross-subsidisation** from one customer group to another as a result of the undertaker receiving supplies of water or wastewater services from a NAV.

As set out in Government’s general Charging Guidance published in January 2016, no category of customer should be unfairly disadvantaged by the impact of certain market reforms on water charges. There must be a fair distribution of costs between customers. This extends to ensuring that charges are fair to future customers as well as current customers. These remain core principles to Government. Ofwat has specific duties in this regard: to ensure that there is no undue discrimination in the setting of charges; to assure that no undue preference is shown; and to have special regard to vulnerable groups. Ofwat must act to protect rural customers and reflect this in relevant principles in setting charging rules.

Ofwat should therefore set charging rules principles which make clear which costs the different charges are designed to recover and which costs they are not expected to recover. The government considers that the **distribution of costs** between undertakers and water/wastewater bill payers should be fair and proportionate.

Averaging of charges is common practice in sectors that have much greater scope for contestability than the water sector does. Ofwat has a number of tools to limit the effect of **de-averaging on customer charges**.

The efficient use of water resources is fundamental to securing the long-term resilience and sustainability of water supplies. Charging has an important role to play in incentivising and securing that efficiency through encouraging innovation and reflecting the true cost of water.

It will therefore be beneficial to use price signals to reveal the value of water and improve recognition of environmental costs. Charges will evolve over time to better reflect the costs of the provision of water in the competitive part of the market. However, this should occur without any de-averaging of network costs. In developing their charging rule principles Ofwat should give appropriate consideration to minimising incidence effects. Any greater cost-reflectivity of charges should be closely regulated to ensure that where changes do occur these are demonstrably in the overall interest of customers.

## **5. Level playing field:**

Ofwat should make provision to review the rules on a regular basis, taking into account the extent and content of price review determinations made and the outcome of consultation. Ofwat should update the rules, when required, to ensure they continue to provide NAVs with a **transparent, efficient, fair, reasonable and effective charging system** that keeps pace with any future developments in the sector- for example, upstream market reforms, policy in relation to water resource management plans and system operators.

In setting Charging Rules in respect of bulk supplies Ofwat should consider the correct **balance of incentives** to ensure that the cost of bulk supplies reflects the environmental, drinking water quality and the economic costs of the trade. It is important to ensure there is a **level playing field** with regards to trades between incumbents and NAVs.

NAV's should be able to have access to **transparent, stable and predictable** charges which allow them to carry out their activities when they can do so more efficiently than incumbent water companies. This includes transparency in publications and consultations.

Ofwat should ensure that rules allow **appropriate margins** that ensure that there is a level playing field between incumbent water companies and the NAVs and eventually lead to benefits to developers and consumers.

Ofwat should ensure that where there is a need to **adjust charges** this is managed to avoid disproportionate impacts on the continuing competitiveness of particular sectors or the bill payers or on the **level playing field**.

# Conclusion

This guidance complements the government's principles to Ofwat on charging rules for the supply of water in bulk between undertakers and NAVs and bulk discharge to incumbents. It exercises the power provided to government in sections 40I and 110J of WIA91 and provides the framework to which Ofwat must have regard in developing charging rules for bulk supplies and bulk discharges.

This guidance sets out additional areas that Ofwat should consider when making charging rules. These relate to environmental costs and customer protection from de-averaging. The guidance is part of a framework of tools to encourage growth by enabling undertakers to better for additional resources to water and wastewater systems by identifying, quantifying and planning for the costs associated with doing so.

Creating a level playing field will also enable new entrants to compete with the existing incumbent water companies for the provision of "upstream" services, such as the sourcing and treatment of water. This will promote more efficient and innovative use of scarce water resources and make it easier for water companies to trade water with each other.