

**ABSTRACTION
CHARGES –
THE CASE FOR
THEIR
EXCLUSION
FROM THE COST
ASSESSMENT
MODELS**

ABSTRACTION CHARGES

THE CASE FOR EXCLUSION FROM THE COST ASSESSMENT MODELS

Abstraction Charges – the case for exclusion from the totex cost assessment models Northumbrian Water, December 2016

At the November 2016 CAWG meeting, there was some discussion about the possible design of a Water Resources cost assessment model. There was a suggestion that it might be appropriate to exclude abstraction charges from the modelling, as a non modelled cost. There was also a suggestion there might be a correlation between water stress status and resource costs.

Northumbrian Water have set out in this note the case for excluding abstraction charges from the totex cost assessment models. The alternative would be to allow series of special cost factor adjustments, but, as abstraction costs apply to all companies and the issues are the same, we felt that exclusion would be more appropriate.

Whilst we have not specifically made the case for it, we suggest that a degree of incentive could be retained for companies to minimise abstraction charges in-period through the totex incentive model.

We have based the points around Ofwat's tests for making wholesale cost adjustments in PR14. These were:

- degree of controllability
- output uncertainty
- cost & timing uncertainty
- materiality

1 Degree of Controllability:

Abstraction Charges are linked to the Administration Costs of the local Environment Agency and are thus not within the control of company management

Abstraction charges are calculated and charged by the Environment Agency on a regional basis, with each region required to be self financing. The 10 regions broadly match the WaSc regions, but not WoC Regions. There are no cross region cost or revenue reallocations by the EA.

Extract from Ofwat & the Environment Agency

The case for change – reforming water abstraction management in England

www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos20111205abstraction.pdf

*Page 21: The Environment Agency recovers the **administrative costs** of managing water resources through the abstraction licensing system. The charges for abstracting water are relatively low and are **not linked to quantities abstracted**. The charges **do not reflect the availability of water resources in each catchment** nor the value society places on the water and the level of protection needed for the environment.*

As the Ofwat report notes, abstraction charges are not linked to the quantities abstracted, but rather to the volumes licensed. Varying the volume licensed does not usually change the total Environment Agency costs to be recovered, which are typically fixed. Thus, even if a company relinquished abstraction licences, it will frequently find its abstraction charges increasing to recover the fixed costs of the Environment Agency.

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This has been the experience of Northumbrian Water in recent years. NWL relinquished around 200MI/day of abstraction licences in 2016/17. With a requirement to recover the unchanged fixed costs, the Environment Agency has been obliged to increase the unit Abstraction Charges to compensate, leaving the NWL abstraction costs unchanged. Note – the local Environment Agency are matches the NWL operating area, so there is little scope for any cost sharing with other abstractors.

The PR14 precedent of including business rates as policy additions to the wholesale water basis cost threshold was based on a similar premise, of a no-controllable cost set by a third party process.

2 Output Uncertainty:

Abstraction charges are not correlated to water stress status

Environment Agency:

Schedule 3 **Water Abstraction Charges** for the year commencing 1 April 2016

The rates of charge for the year commencing 1st April 2016 are as follows: Regional charging area	2016/17 Standard Unit Charge (£/1000m3)	2013 Water Stress Classification (EA)
Anglian	27.51	Serious
Midlands	14.95	Not serious
Northumbria	29.64	Not serious
North West	12.57	Not serious
Southern	19.23	Serious
South West (incl. Wessex)	19.71	Not Serious
Thames	13.84	Serious
Yorkshire	11.63	Not serious
Dee	13.58	Not serious
Wye	13.58	Not serious

There is some correlation between abstraction charges and water stress status for Anglian, North West and Yorkshire. However the 'Serious Water Stress' Thames area has abstraction charges significantly lower than three 'Not Serious Water Stress' areas; Northumbria, South West and Midlands. This suggests that the Water Stress status is not a good proxy for Abstraction Charges.

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Environment Agency: Water Stressed Areas – 2013 Final Classification

Water Company Area	2013 Classification					Final Stress
	Current Stress	Future Scenario 1	Future Scenario 2	Future Scenario 3	Future Scenario 4	
Affinity Water (formerly Veolia Water Central)	S	S	S	S	S	Serious
Affinity Water (formerly Veolia Water East)	S	S	S	S	S	Serious
Affinity Water (formerly Veolia Water South East)	S	S	S	S	S	Serious
Anglian Water	S	S	S	S	S	Serious
Bristol Water	M	M	M	M	M	Not Serious
Cambridge Water	M	M	M	M	M	Not Serious
Cholderton & District Water	M	M	M	M	M	Not Serious
Dee Valley Water	M	M	M	M	M	Not Serious
Dwr Cymru Welsh Water	M	M	M	M	M	Not Serious
Essex & Suffolk Water	S	S	S	S	S	Serious
Northumbrian Water	M	M	M	M	M	Not Serious
Portsmouth Water	M	S	M	S	M	Not Serious
Sembcorp Bournemouth Water	L	M	M	M	L	Not Serious
Severn Trent Water	M	M	M	M	M	Not Serious
South East Water	S	S	S	S	S	Serious
South Staffordshire Water	M	M	M	M	M	Not Serious
South West Water	M	M	M	M	M	Not Serious
Southern Water	S	S	S	S	S	Serious
Sutton & East Surrey Water	S	S	S	S	S	Serious
Thames Water	S	S	S	S	S	Serious
United Utilities	M	M	M	M	M	Not Serious
Veolia Water Projects	M	M	M	M	M	Not Serious
Wessex Water	M	M	M	M	M	Not Serious
Yorkshire Water	M	M	M	M	M	Not Serious

3 Costs & Timing Uncertainty

Abstraction charges do not follow a predictable path

Looking at the abstraction charges since 2012-13, rebased so that 2012-13 = 100, there is no clearly discernible pattern (monotonic rising; monotonic falling; static) which would render such charges forecastable.

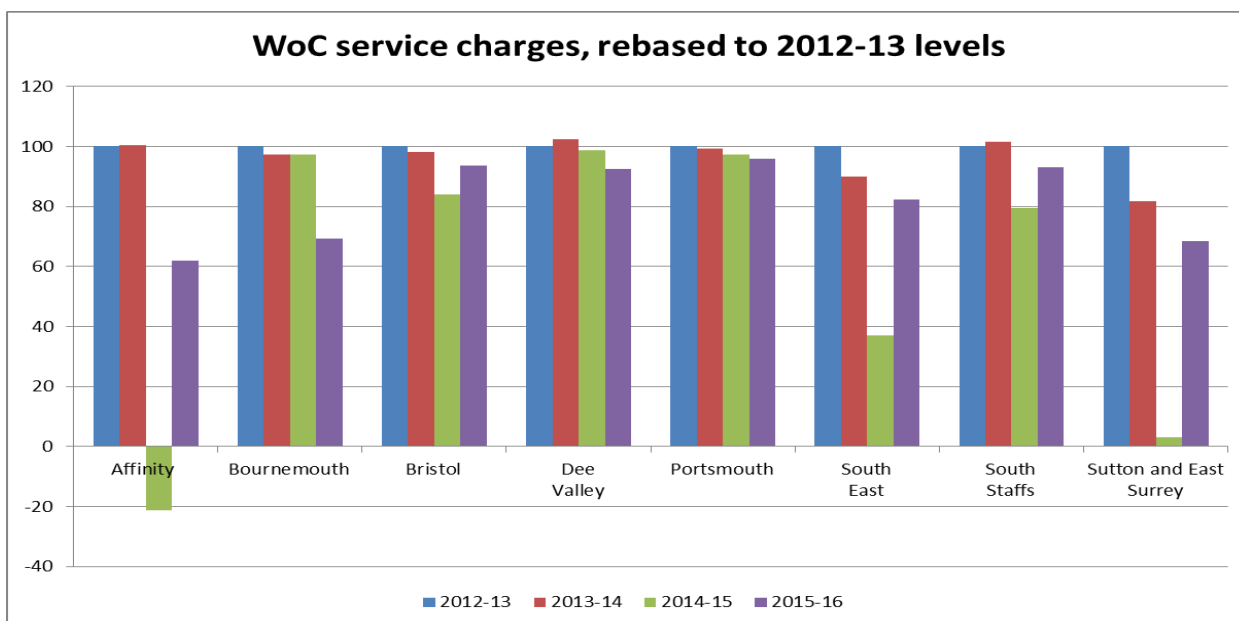
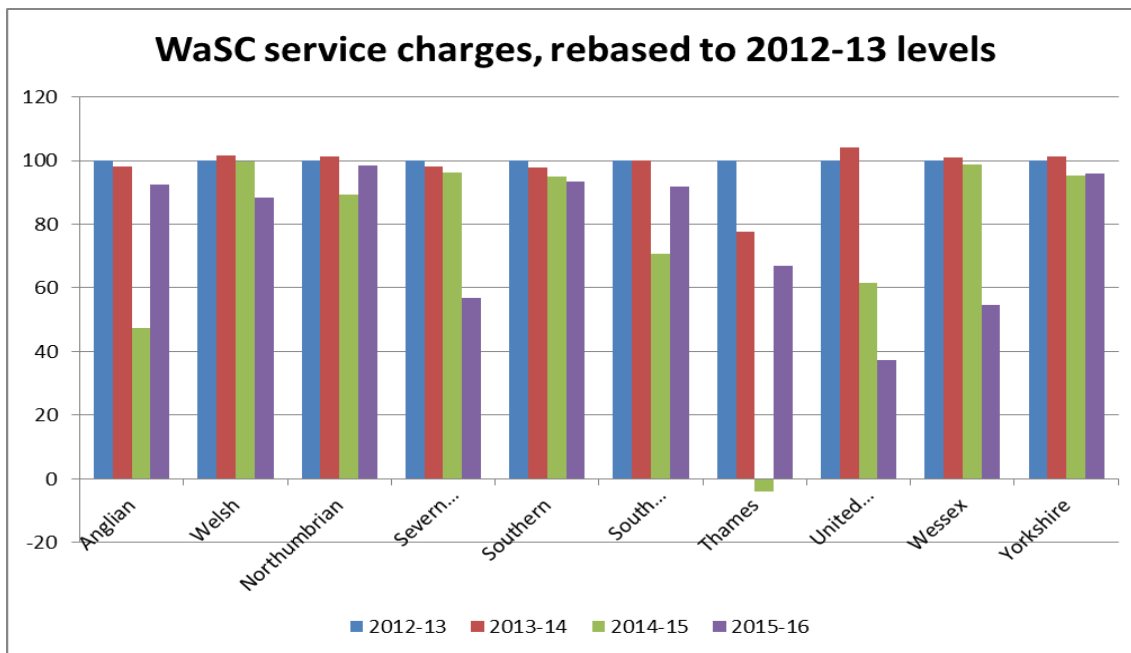
The timing of any changes to abstraction charging regime is uncertain

Whilst there have been recent consultations on reforming abstraction charges¹, these have centered on the permitting regime and confirmed that the charging regime would still be based on cost recovery. The consultation refers to reform 'in the early 2020's', but this was stated before the Brexit vote, which seems likely to delay such reforms.

¹ Water abstraction management reform in England: What would reform mean for abstractors? 15 January 2016

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4 Materiality

Abstraction licence charges were 2.5% of industry water service totex but were 24% of water resource totex in 2015/16.

The threshold for materiality for special cost factors in PR14 was 0.5% of service totex, so abstraction charges are clearly material whether they are part of a water wholesale model or a water resources model.

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5 Consistency with past regulatory approaches

Abstraction Charges were excluded from Ofwat’s Water Resource Opex Efficiency Models in the past.

Prior to the move to totex efficiency models in PR14, Ofwat used a Resources and Treatment Model to assess opex efficiency. The model deducted service charges (abstraction charges) before carrying out cost comparisons. This was a generally accepted modelling adjustment and was the equivalent of ‘costs excluded from the menu’ in current terms.

Extract:

http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/regulating/casework/reporting/rpt_unc_2006-07watermodel.xls

2006-07 model	T21 - L12 BM111	T21- L7 BM131	T21-L2 BM102	
	Water R&T: Functional expenditure A	Water R&T: Service charges EA B	Water R&T: Power C	R&T Opex (no adjustment for softening) A-B-C
	£m	£m	£m	£m
Anglian	43.92	8.82	13.34	21.76
Dŵr Cymru	43.06	8.78	10.29	23.99
Northumbrian	54.19	18.75	7.94	27.50