

Department for Environment, Food and Rural Affairs

## Water Bill

# Upstream Competition and Abstraction Reform

March 2014

This is one of a series of briefing notes on the Water Bill. This note explains how reforms in this Bill to the market for water supply and sewerage services will interact with the regime for ensuring water is sourced sustainably. Further detail on the Water Bill can be found in other briefing notes.

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## Context: the case for change

We are facing growing pressures on our water resources as a result of a changing climate and population growth – and we know that these future pressures will not be limited to the south and east of England. Over-abstraction is already harming the ecological health of some catchments. The UK Government's 2011 Water White Paper *Water for Life* set out an evidence-based case for change in the context of a future in which there will be less water available for people, businesses and the environment.

We will therefore need to reconsider how in the future we manage water resources to ensure continued protection of future water ecosystems and make water available for abstraction. The White Paper recognised that demand management will have an important role to play in addressing these challenges, but that new water resources will also need to be developed.

In response to these challenges the Water White Paper identified a number of priorities including action to: tackle unsustainable abstraction, manage demand more effectively, develop new water resources; reduce waste and ensure that customer bills remain fair and affordable. All of this will require greater efficiency, flexibility and innovation from the water industry.

**NB The Welsh Government has taken the decision not to implement all of the upstream reforms at this time for incumbent water and sewerage companies' areas wholly or mainly in Wales. References to upstream competition in this briefing note therefore generally refer to areas of England served by water and sewerage companies that operate wholly or mainly in England.**

## Upstream Competition Reforms

The upstream reforms set out in the Water Bill will support these priorities by making it easier for new players to enter the water sector who might offer new water sources, water efficiency goods and services or innovative ways for dealing with wastewater and sewage sludge. This will both increase the scope for innovation and entry into the sector and increase the incentives on incumbent water companies to identify the most environmentally and economically efficient options for meeting future resource requirements. These reforms will also make it easier for water companies to trade water with each other, increasing flexibility in the system, particularly during periods of drought.

These relatively modest changes to the existing system are designed to benefit both customers and the environment. For example, increasing competition could improve incentives for water companies to adopt more water efficiency measures and innovative treatment and disposal services, recycle more waste water, capture rainwater and reduce waste. Reducing pressure on public water and sewerage systems will deliver benefits to

the entire customer base not just to those businesses that take up the opportunities presented by our upstream reforms.

The implementation of upstream markets is just one part of the Government's wider agenda for securing the long-term resilience of our water supplies and the water environment, which was set out in the Water White Paper. This includes, for example, the statutory water resources management planning process and our plans for long-term reform of the abstraction regime. The common theme across this agenda is our commitment to achieving the right balance between long-term planning, environmental regulation and the use of market mechanisms to secure the most efficient use of scarce water resources.

## Abstraction Reform

The Government's plans for abstraction reform are another key aspect of this agenda. The UK Government is committed to introducing a reformed water abstraction regulation system in England able to promote resilient economic growth while protecting the environment in a manner which is fair and adaptable to future uncertainty at a reasonable cost. The Welsh Government is committed to ensuring sustainable management of water resources in Wales, including considering options for the future management of the abstraction regulation system in Wales.

We are committed to tackling the unsustainable abstraction we see today, as well as reforming the regime for the future. This requires a twin track approach – taking action now, using and improving the tools we already have available, to address the over abstraction, while ensuring that we put in place a reformed regime which is fit to face the challenges of the future.

We have intensified our work to restore sustainable abstraction to our rivers today by varying and removing abstraction licences. Through the Restoring Sustainable Abstraction programme, the Environment Agency is currently returning around 75 billion litres of water per year to the environment. This is the equivalent to the daily average water use of a city larger than Birmingham. It has reviewed thousands of abstraction licences and has already changed 77 licences in England. Since 2008, the Environment Agency has made changes to licences that have benefitted almost 400 km of rivers in catchments across England. Similarly, 44 licences have been changed in Wales. Some successful examples of the Restoring Sustainable Abstraction programme include: the River Darent, one of England's iconic chalk rivers, that will be safeguarded in the future after licence changes came into force in February 2013; Brennand and Whitendale, where water will be taken more sustainably from the Rivers Ribble and Brennand; and reducing abstraction to protect the Dartmoor Special Area of Conservation. The Environment Agency and Natural Resources Wales continues to work closely with water companies, and other abstractors, to improve river flows.

The UK and Welsh Governments are also considering how to bring currently exempt abstractors, such as trickle irrigators, into the licensing regime and aim to consult jointly in 2014.

The Water Bill also includes one significant change which will enable a more effective approach to tackling over abstraction by water companies. We will remove the water company statutory right to compensation for losses resulting from modifications and revocations of their abstraction licences. This fulfils a Government commitment in the Water White Paper to consider a framework which integrates water company schemes to restore sustainable abstraction into their mainstream business planning and provides funding through the Ofwat Price Review process. This will provide a more effective funding mechanism, enabling water companies to consider more holistic and strategic solutions to addressing unsustainable abstraction, within the wider context of balancing their supply and demand.

Over the longer term, the Government is reforming the abstraction regime to make it more flexible and resilient to the challenges of climate change and population growth. The new system will be more responsive to the amount of water available in a catchment. Public water supply and non-public water supply trading will not affect environmental protection. Trading should facilitate the more efficient use of water that is abstracted.

Reforming water abstraction is not part of the current Water Bill. The UK and Welsh Governments are working together to develop water abstraction reform options with stakeholders. The options were published for formal consultation in December 2013. We should not rush this: if we get it wrong there will be real consequences for a range of businesses and industry, including farmers, food manufacturers and the power sector, as well as the environment.

## Timeframes for reform

The Water Bill includes reform of the existing upstream water markets as part of wider market reforms of the water industry. The upstream reforms will require careful planning and close working between the water industry, regulators and customer representatives. To allow sufficient time for this, the main upstream reforms will not be implemented in advance of the next Price Review which will set charges for 2020 – 2025.

We are aiming to legislate for abstraction reform early in the next Parliament (from 2015) with a view to implementation in the early 2020s.

We have committed to ensuring that the implementation of our upstream and abstraction reforms are carefully co-ordinated, with the timetable for expansion of upstream water resource markets and transition to a new abstraction regime likely to be broadly similar. This will enable abstractors to take decisions about managing their water use with good information about how future regulation will operate and the role markets might play in enabling them to meet their water needs.

## Concerns about unintended consequences

Some stakeholders have raised concerns that legislating for upstream reform in advance of abstraction reform may lead to unintended consequences for the water environment. The two key areas of concern that have been raised are:

- a. Upstream reform could provide an incentive for non-water company abstractors that are not currently utilising their full licensed volumes ('sleeper' licences) to increase use unsustainably; and
- b. Upstream reform could provide an incentive for water companies that currently have 'headroom' within their abstraction licences to increase use unsustainably for the purposes of trading between water companies.

The Government is clear that any such outcome would be wholly unacceptable. Ofwat, Defra and the Environment Agency have carefully considered the issue and are confident that the existing regulatory framework, correctly applied, is fully capable of managing these risks.

### 'Sleeper' licences

In order to sell water into public supply, all non-water company abstractors will need to apply to the Environment Agency<sup>1</sup> for a "change of use" for their abstraction licence. They would be required to go through the same process as if applying for a totally new licence. The Environment Agency can therefore refuse a "change of use" request if it would lead to unsustainable abstraction or deterioration in the catchment or it could apply conditions to ensure that this did not happen. However, the Government intends to amend the Bill to enable regulations about water supply agreements between incumbent water companies and other relevant parties to require Ofwat to consult the Environment Agency or Natural Resources Wales before ordering, varying or terminating such an agreement.<sup>2</sup>

In addition to the existing process for issuing abstraction licences and regulating change of use, there are separate licensing requirements for new entrants to the water sector. This ensures that new entrants are only issued with water supply licences if they meet the standards of governance, transparency and behaviour required in the context of economic regulation<sup>3</sup>. The Government amended the Bill in Committee in the House of Commons to require Ofwat to consult the Environment Agency before issuing a water supply licence entitling the holder to input water into the public supply system. This is quite separate from, and does not in any way duplicate, the Environment Agency's role in abstraction licensing.

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<sup>1</sup> Natural Resources Wales for abstractors in Severn Trent's water supply area in Wales

<sup>2</sup> A Government amendment is planned for Report stage in the House of Lords.

<sup>3</sup> For example, the new entrant must pass a 'fit and proper person test'.

The Environment Agency is the appropriate body to regulate abstraction. However, Ofwat will attach complementary conditions to the water supply licence to ensure that there is consistency between the economic and environmental licensing regimes. These conditions will stipulate that all water put into the public water supply must be abstracted under the correct licence for that purpose. Water supply licensees will be required to hold an appropriate abstraction licence for any water that they themselves abstract; and inform the Environment Agency about any trades with other abstractors. Failure to comply with these requirements would constitute a breach of the water supply licence.

The Environment Agency will require that any abstractor supplying water to a water supply licensee for input to public water supply holds an abstraction licence for that purpose.

These safeguards will ensure that there is no practical risk of an unsustainable increase in abstraction by non-water companies or water supply licensees in response to the implementation of upstream reform.

## Bulk supplies

There are several bulk supply arrangements in place already between incumbent water company areas, which enable incumbent water companies to supply water to each other. The majority of these agreements have been in place for a long time. The Water Bill reforms the existing bulk supply regime by making it easier for incumbent water companies to enter into these agreements with each other. However, this does not mean that water companies will be free to make transfers that damage the environment.

Ofwat can only order, vary or terminate a bulk supply agreement at the application of one of the parties. Ofwat must balance a number of factors before making this decision. This includes the ability of the supplier to meet its existing obligations, or likely future obligations, to supply water as well as facilitating effective competition. However, Ofwat's decision to order, vary or terminate a bulk supply agreement is fundamentally based on whether it is necessary or expedient to do so for the purposes of securing the efficient use of water resources or the efficient supply of water.

Ofwat must also consult the Environment Agency or Natural Resources Wales before ordering, varying or terminating a bulk supply agreement. The Government intends to amend the Bill to require Ofwat to consult, in particular, on whether the proposed supply would secure an efficient use of water resources, in light of its effect on the environment.<sup>4</sup> Any response from the Environment Agency or Natural Resources Wales would have to be taken into account. It would be difficult for Ofwat to order a bulk supply agreement in light of representations from the relevant environmental regulator that the agreement entailed a high risk of over-abstraction.

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<sup>4</sup> A Government amendment has been tabled for Report stage in the House of Lords.

The Government intends to amend the Bill to require parties that freely enter into bulk supply agreements to consult the appropriate agency as well.<sup>5</sup> This means that the Environment Agency and Natural Resources Wales will have the opportunity to feed into the process at the outset in respect of all bulk supply agreements. In addition, incumbent water companies have statutory environmental duties to prevent them from entering into bulk supply 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 bulk supply 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.

In May 2013 the Environment Agency issued a technical briefing note which places clear responsibility on the supplying water company to take account of the risk of deterioration when considering how a bulk supply to another water company is to be resourced. The Environment Agency can also propose that one water company makes a supply to another to help resolve water shortage issues in England. The Environment Agency will continue to control the impacts of abstraction through abstraction licensing. The Government also intends to amend the Bill to add an enforceable duty on the supplying party to a bulk supply agreement to provide information about the water supplied under the agreement at the request of the Environment Agency or Natural Resources Wales.<sup>6</sup> This could include the source or timing of the water supplied under the agreement.

Ofwat has already established a Trading and Procurement Code, which includes a sustainability clause, to mitigate against possible environmental risks of trading, in response to the Water Trading incentive in the current Price Review. The Government intends to strengthen the codes on bulk supply agreements by amending the Bill to add a requirement for Ofwat to consult the Environment Agency and Natural Resources Wales before it issues the codes.<sup>7</sup>

These safeguards will ensure that there is no practical risk of an unsustainable increase in abstraction as a result of reforms to remove barriers to bulk supplies between water companies.

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<sup>5</sup> A Government amendment has been tabled for Report stage in the House of Lords.

<sup>6</sup> A Government amendment has been tabled for Report stage in the House of Lords.

<sup>7</sup> A Government amendment has been tabled for Report stage in the House of Lords.

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