

Water for Life

Market reform proposals

December 2011

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Contents

Market reform in the water sector 2

Increasing the size of the competitive market..... 4

Ensuring fair and contestable markets 6

Policing the competitive market..... 9

Increasing upstream competition..... 11

Reform of the inset regime 12

Reform of the special merger regime 14

Ofwat regulation 16

Protecting customers..... 17

Market reform in the water sector

1.1 The case for reform of the water industry to develop a more vibrant and competitive market was set out in Professor Martin Cave's report to Government: *Competition and Innovation in Water Markets*¹. While recognising the successes of the sector since privatisation, he concluded that change was needed to deliver higher levels of customer service and tackle the challenges facing the industry, such as climate change. Martin Cave recommended a package of changes to increase competition and bring new approaches and new ways of working to the sector.

1.2 The Water White Paper includes the Government's response to the recommendation in the *Review of Ofwat and consumer representation on the water sector*² that Government should provide greater clarity to the sector on its plans for the extension of competition. It sets out our plans for reform, building on the strengths of the current industry structure and regulatory regime and reflecting Martin Cave's recommendation that change should be evolutionary and introduced step by step.

1.3 This paper adds more detail to the announcements made in the Water White Paper around market reform. In particular it covers reforms to the water supply licensing (WSL), inset and special merger regimes that were introduced by the Water Industry Act 1991 (as amended).

"We found a widespread desire among stakeholders for greater clarity on market reform agenda.

"Martin Cave recommended a measured approach to the introduction of further competition in the water sector. Some of the companies, and their investors, have been concerned that Ofwat seemed to intend more extensive and rapid moves towards markets and competition than was envisaged by the Cave Review.

"Most respondents to the call for evidence clearly regarded the approach to competition as a policy matter for which Government should therefore take responsibility. In this case, however, there is a default policy setting already reflected in Ofwat's existing duties. The consumer duty requires it to protect the interests of consumers, wherever appropriate by promoting effective competition. The dividing line between Government and Ofwat is therefore less clear than the simple statement that policy is for Government would suggest. If Government does not wish Ofwat to pursue the introduction of competition it would need to change that primary duty.

"As an extension of competition is likely to require legislation, Ofwat needs to work closely with the UK and Welsh Governments to implement their proposals. In setting out its policy statement it would seem reasonable for Government to be clear as to its interpretation of the qualification "wherever appropriate" by setting out its views on how far and how fast competition should be introduced. Government should also express views on any protections it might see as appropriate for particular groups of customers.

¹

<http://webarchive.nationalarchives.gov.uk/20100713155800/http://www.defra.gov.uk/environment/quality/water/industry/cavereview/index.htm>

² <http://www.defra.gov.uk/publications/2011/07/06/pb13587-ofwat-review-2011/>

“Recommendation 20 of the Ofwat review: The UK Government should take the opportunity of the forthcoming Water White Paper, to set out clearly its future policies for the water sector and the roles of the regulators in implementing those policies. The Welsh Government should also clarify any changes to its policy position since the Welsh Assembly election.

Review of Ofwat and consumer representation in the water sector

1.4 We have decided not to introduce fundamental structural change to the industry such as requiring legal separation of water companies’ retail functions. We do not want to take risks with a successful model given the challenges we face in building the resilience of the sector. The retail competition impact assessment that is also published alongside the White Paper outlines the options the Government considered when developing market reform policy. The impact assessment took account of evidence published since the last Government published its consultation³ on the Cave review recommendations. These options include Martin Cave’s recommendation to legally separate the retail functions of water companies as well as functional and voluntary separation, which were put forward as alternative approaches by respondents to the consultation.

1.5 The policies outlined in this paper are also informed by an impact assessment on upstream competition, which is also published alongside the White Paper.

Retail impact assessment options:

Option 1 - do nothing (the base case).

Option 2 - reform of retail element of the water supply licensing regime (WSL) plus legal separation of retail functions from wholesale business.

Option 3 - reform of retail element of WSL plus functional separation of retail functions.

Option 4 - reform of retail element of WSL plus optional separation of retail functions.

Option 5 - reform of retail element of WSL without any form of separation (the preferred option).

Upstream impact assessment options

Option 1 – no change to legislation but a change in way Ofwat regulates upstream (the base case).

Option 2 – reform of upstream element of WSL.

Option 3 – reform of upstream element of WSL plus replacement of inset regime by introduction of network licence in the WSL (preferred option).

³ <http://webarchive.nationalarchives.gov.uk/20100713155800/http://www.defra.gov.uk/corporate/consult/cave-review/index.htm>

Increasing the size of the competitive market

“Extending choice for non-household customers “On the basis of responses to the interim report, I now believe that there may be practical benefits from abolishing the non-household threshold, rather than retaining a one megalitre threshold with aggregation, on the introduction accompanying measures.”

“The decision on whether and when to extend retail competition to other customers should be taken by the UK and Welsh Assembly Governments and the UK Parliament and National Assembly for Wales on the basis of advice from Ofwat and other parties after consultation with stakeholders.”

Independent review of competition and innovation in water markets: Final Report.

2.1 The Water Act 2003 put in place a framework for a limited retail market for water, enabling very large water customers that use 50 megalitres or more of water per year to switch suppliers. The market for water supply therefore only consisted of 2,200 potential customers across England and Wales. Despite there being seven new entrants holding water supply licences, to date only one customer has switched its supplier in six years. In Scotland a less burdensome regulatory regime with no eligibility threshold has seen a number of non-household customers switch and many more customers benefit from lower charges and a wider range of services.

WSL licensees in England and Wales	Retailers in Scotland
Avon Valley Water Ltd	Aimera Ltd
Osprey Water Services Ltd	Osprey Water Services Ltd
Satec Ltd	Satec Ltd
Scottish Water Business Stream Ltd	Scottish Water Business Stream Ltd
Severn Trent Select Ltd	Wessex Water Enterprises Ltd
United Utilities Water Sales Ltd	
Yorwater Ltd	

2.2 On 31 October the Government announced that it was to reduce the eligibility threshold to 5 megalitres of water a year for England⁴. The draft *Water Supply (Amendment to the Threshold Requirement) Regulations 2011*⁵ were laid before Parliament on that day and are due to come into force by the end of the year. This will increase the size of the market to approximately 26,000 non-household customers in England and should capture most large manufacturing and food processing businesses.

⁴ In this context “England” means the areas not served by water companies that are wholly or mainly in Wales

⁵ <http://www.legislation.gov.uk/ukdsi/2011/9780111516478/contents>

2.3 The 5 megalitres threshold was recommended by the Cave review as being the largest market possible with the current customer transfer protocol⁶. Ofwat updated its WSL guidance⁷ in September 2011 in anticipation of the lowering of the threshold.

2.4 In due course a future Water Bill will also extend choice to all non-household customers by removing the threshold provision from primary legislation. This will mean that a much more sophisticated customer switching mechanism will need to be put into place by Ofwat. Work on this is being taken forward as part of the project to develop market codes and common systems (see paragraph 3.4).

2.5 The Welsh Government has announced its intention to retain a 50 megalitre eligibility threshold in the areas served by water companies wholly or mainly in Wales (i.e. Dwr Cymru Welsh Water, Dee Valley and Albion Water in Wales).

Eligible customer in England at each threshold (estimates)

Water consumed (megalitres per year)	No. of customers in England
Non-household premises >50	2,180
Non-household premises >5	26,000
All non-household premises	1,146,200

2.6 Non-household customers that use 50 megalitres of water a year (250 megalitres in the area of water companies wholly or mainly in Wales) may also individually or collectively replace their monopoly water company with an alternative supplier under the large user criterion in the inset regime. Once all the WSL reforms are put into place it is the Government's intention to remove the large user criterion from the inset regime because the WSL is going to provide a much more flexible and less burdensome regime for regulators, customers and new entrants (e.g. WSL licensees are not required to produce water resource management or drought plans while some inset appointees are required to do so). However, the orders that underpin the large user criterion will be scrutinised under the Government's Red Tape Challenge⁸ which is taking place early next year. Stakeholders and members of the public will therefore have an opportunity to comment on the orders and suggest an alternative threshold, etc. The Government will consider whether there are any changes that could be taken forward in the light of these comments and suggestions.

2.7 The Government does not believe there is a case in the foreseeable future for opening up the household market to competition and we will not be seeking powers to extend the WSL in this way in the next Water Bill. This is consistent with the Cave recommendation that Parliament should decide whether competition should be extended in the future.

2.8 Where there are "mixed-use premises" (e.g. where a customer owns a single set of premises made up of household and non-household elements, for example health workers'

⁶ http://www.ofwat.gov.uk/competition/wsl/pap_con_1002ctp.pdf

⁷ http://www.ofwat.gov.uk/competition/wsl/gud_pro_wslelig.pdf

⁸ <http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/>

accommodation on a hospital site), Ofwat's guidance defines eligible sites as being non-household where both of the following apply: the household part of the premises is dependent in some way upon the non-household part. For example, a university hall of residence would not exist in the absence of the university itself; and the premises are liable for business rates (or if exempt from business rates are one of the specified types of premises in Ofwat's guidance).

Ensuring fair and contestable markets

“Recommendation 6 of the Cave review: Consistent with a step-by-step approach I recommend reforming the current water supply licensing regime and supplementing it with a market-like framework as soon as practicable.

- *unbundling the current combined supply licence and creating a new upstream licence for companies wishing to introduce raw or treated water into an incumbent's network or remove and treat wastewater or treat and dispose of sludge from it. There should also be a network licence for those looking to provide infrastructure. The current structure of licences for incumbents would remain as now;*
- *for supplies to incumbents, replacing the costs principle with an ex-ante access pricing framework based on full economic costs. Access prices would be determined by Ofwat at a water resource zone level on a common methodology with reference to guidance from Defra and Welsh ministers. Such an approach should ensure that:*
 - *an efficient network operator is able to cover their costs;*
 - *tariffs are non-discriminatory and cost-reflective; and*
 - *efficient entry is supported.*
- *for supplies to retailers or large customers, replacing the costs principle with an ex ante access pricing framework based on long-run avoidable costs. Access prices would be determined by Ofwat at a water resource zone level on a common methodology, with reference to guidance from Defra and Welsh ministers. Such an approach should ensure that:*
 - *an efficient network operator is able to cover their costs;*
 - *tariffs are non-discriminatory; and*
 - *efficient sources of supply are supported.*
- *introducing common operational codes and systems, binding on all market participants;*
- *creating powers for Ofwat to undertake proactive investigations of noncompliance; and*
- *ensuring that the Drinking Water Inspectorate has appropriate powers and resources to maintain the quality of, and confidence in, the wholesomeness of the water supply.”*

Independent review of competition and innovation in water markets: final report.

3.1 Meaningful choice is only likely to develop with the entry of new market players. Alongside increasing the size of the market, we will also make it easier for new entrants to enter the market and for customers to switch by removing barriers in the existing legislation.

3.2 The proposals to reform the WSL regime will bring it closer to the one in Scotland. We will establish a larger market for retail water and sewerage services across England and Scotland (plus for those eligible customers in Wales) in partnership with the Scottish Government. This will enable Ofwat and the Water Industry Commission for Scotland (WICS) to mutually recognise each others' licensees, removing the need to be licensed by two separate regulators; share information for enforcement purposes; and produce joint charging rules and market codes to regulate the GB-wide market.

Current differences between the GB competition regimes

England and Wales	Scotland
Competition in water supply services only.	Competition in water and sewerage services.
Retail and common carriage is permitted.	Competition restricted to retail services.
Incumbents are vertically integrated, regional monopoly companies.	Scottish Water is sole appointed water company in Scotland. Legal separation of its retail arm into Scottish Water Business Stream.
Eligibility threshold of 5 megalitres in legislation in England and 50 megalitres in Wales.	All non-household customers eligible to switch suppliers.
Prescribed costs principle (retail minus) contained in legislation.	Regulator sets access charges, but Scottish Ministers can give guidance on charging principles.

3.3 Currently a WSL new entrant has to set up a ring-fenced limited company to qualify for a licence. This requirement does not feature in any other regulated sector, such as energy, post or telecoms. We will use a future Water Bill to remove this barrier for retail-only licensees. This will enable both Scottish water retailers and other utility companies or service providers to enter the retail market even if they are not a limited company. This also means that incumbent water-only companies could apply to Ofwat for a retail sewerage licence and sewerage only companies could apply for retail water supply licences without setting up a limited company for the purpose. Entrants and incumbents that could potentially be caught by the special administration regime will still be required to set up ring-fenced limited companies (i.e. upstream operators and inset appointees).

3.4 A future Water Bill will introduce a new, regulated approach to market entry that will remove the need for a new entrant to negotiate the terms of its entry separately with each of the incumbent water companies. Ofwat has made some progress on this issue with the development of a common contract. However, we will replace the current approach with a more transparent, regulated approach. This will include the introduction for the first time in primary legislation of a requirement for an economic regulator to produce statutory market codes that will set out the respective roles, duties and responsibilities of all market

participants, Ofwat, the DWI and the Environment Agency. Standard terms and conditions will remove uncertainty surrounding negotiations, be much clearer and make customer switching simpler.

3.5 We will make it more attractive for customers to consider switching their suppliers by using a future Water Bill to extend the WSL regime to include sewerage services. This will offer customers more choice, and may be particularly helpful in those parts of the country where customers receive separate bills for water and sewerage. Extending the WSL to include upstream sewerage services will enable licensees to draw out and input wastewater into a sewerage company's drainage and storage systems to provide services on behalf of its own customers and other new entrants. This will allow new entrants to treat, recycle and/or dispose of wastewater from the sewerage company's system as well as inputting wastewater for treatment. This will incentivise the development of a market for treated and untreated wastewater as alternatives to potable supplies for large industrial users.

3.6 Barriers in legislation prevent some licensed water suppliers from offering customers the services they want. For example, large multi-site businesses, such as retail chains, would like to deal with a single supplier for all their water and sewerage needs, which could significantly reduce their administrative costs. The current in-area trading ban prevents a licensed water supplier set up by an existing water company from supplying water in the area covered by its associated company. This prevents them from aggregating contracts nationally, while independent licensed water suppliers are free to do so. The last Government accepted a recommendation made by Ofwat in its review of competition⁹ to remove this uncompetitive ban. We will legislate to remove this restriction and put all market players on a level footing. This will be done at the earliest opportunity either in a future Water Bill or a general Repeals Bill, whichever comes first.

3.7 Increasing transparency in charges will make it more attractive for businesses to enter the water and sewerage market and sharply reduce the risk of discriminatory pricing. Access prices are currently governed by the costs principle set out in section 66E of the Water Industry Act 1991 (as amended), which has been widely criticised as being anti-competitive and for giving little incentive to incumbent water companies to become more efficient. The costs principle currently follows a particularly restrictive "retail minus" approach, whereby the discount that licensees receive is limited to "ARROW" costs net of any additional costs incurred by the incumbent water company in providing access. ARROW costs are defined as expenses that can be **A**voided or **R**educed, or any amount that is **R**ecoverable in some **O**ther **W**ay (other than from other customers). So this may mean that "sunk costs" (e.g. fixed costs of a call centre or billing system) must be included in the access price which does not produce much of a margin on which a new entrant can compete.

3.8 We will use a future Water Bill to remove the costs principle from legislation and instead introduce a transparent access pricing regime which will require incumbent water companies to produce wholesale charging schemes based on enforceable charging rules produced by Ofwat and, where appropriate, WICS. The Secretary of State will have a power to produce guidance on the setting of charges which Ofwat will have regard to when producing its rules. We will also introduce a similar wholesale charging mechanism for the inset regime where developers choose a new entrant to be the water company for a new development.

⁹ http://www.ofwat.gov.uk/competition/wsl/pap_con_mktcomp.pdf

3.9 Increasing competition provides opportunities to improve the efficiency of networks and to increase resilience. The new WSL charging regime will include a right for new entrants to negotiate discounts for non-household customers that reduce pressure on networks, for example through investing in a sustainable drainage solution that significantly reduces discharge into the public sewer system. Other examples might be putting into place arrangements for large users to stop or reduce their water use during peak seasons or drought, or equally making any spare water available to the public during such periods. This new regime will be similar to the so called “section 29E” provision in Scottish legislation which allows Scottish retailers to negotiate discounts with Scottish Water. Such arrangements must not result in increased costs to other bill payers in order to qualify for discounts.

3.10 The reformed WSL will also introduce a “self-supply” licence for suitably qualified customers to become their own “new entrant”. This will enable customers to purchase water and sewerage services in wholesale markets and put their own water resources or that of another WSL licensee into an incumbent’s supply system in order to supply its own premises.

3.11 As with other WSL licensees, these customers will be able to access spare water owned by incumbent water companies in neighbouring areas through the secondary supply regime. Licensed water suppliers are already able to source spare water on behalf of their customers from neighbouring water companies under the secondary supply regime. This puts neighbouring water companies under a qualified duty to make the necessary arrangements to input its water into the network of the water company supplying the customers. This type of arrangement will also be introduced so that new entrants can access spare wastewater treatment capacity in neighbouring sewerage company areas.

Policing the competitive market

4.1 The retail market for water and sewerage services will remain a regulated market. Ofwat will need to use its regulatory or concurrent competition powers smartly to prevent and discourage incumbent companies from discriminating against new entrants in favour of their own retail businesses either through the prices they charge or by other non-price forms of anti-competitive behaviour (e.g. giving preferential treatment to its own retail business when handling quotes, information requests, inputting water resources into the network, etc). The Government would expect Ofwat or another competition authority to take firm action where there is evidence of discriminatory pricing or behaviour. Tools at their disposal include the power to require undertakings from market participants to address anti-competitive behaviour.

4.2 The Department for Business, Innovation and Skills (BIS) will be announcing in the New Year its proposals for reforming the competition framework, which will include proposals for improving the way concurrent competition powers are used by the competition authorities. This follows publication of a consultation¹⁰ on the competition regime in March 2011. Ofwat has concurrent competition powers to enforce the prohibitions against anti-competitive agreements and practices of the Competition Act 1998 and Articles 101 and 102 of the Treaty on the Functioning of the European Union.

¹⁰ <http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/c/11-657-competition-regime-for-growth-consultation.pdf>

Ofwat also has concurrent powers to make a Market Investigation Reference to the Competition Commission under the Enterprise Act 2002.

“Competitive markets drive productivity and growth, and an effective competition regime is central to providing them. The current UK competition regime is world-class, but there is still scope for improvement. The Government’s overarching objective in reforming the competition regime is to maximise the ability of the competition authorities to secure vibrant, competitive markets that work in the interests of consumers, to promote productivity, innovation and economic growth.

To achieve the Government’s overarching objective, it is therefore consulting on change to:

- ***improve the robustness of decisions and strengthen the regime*** – enhancing the regime’s ability to resolve and deter the competition restrictions that do most harm to competition, consumers and to economic growth, while ensuring that the regime retains the flexibility to strengthen its processes as the regime and economy evolve;
- ***support the competition authorities in taking forward high impact cases*** - developing the regime’s ability to target the competition restrictions that do most harm to competition, consumers and to economic growth, and providing the regime with the tools and flexibility to make proportionate and focused interventions;
- ***improve speed and predictability for business*** – building on the regime’s ability to take the timely, proportionate and predictable actions that limit burdens on business and that provide for the certainty that enables business to invest and innovate with confidence.

In this connection, the Government is consulting on a proposal to merge the competition functions of the Office of Fair Trading and the Competition Commission to create a single Competition and Markets Authority (CMA), which can play a leading role in achieving the overarching objectives and delivering the desired outcomes. Key arguments for the single CMA are to ensure the flexible allocation of scarce public resource to competition issues as they emerge, and for it to be a stronger advocate for pro-competition policy across government, including in the delivery of public services.”

**A competition regime for growth: a consultation on options for reform,
Department of Business Innovation & Skills**

4.3 The development of water and sewerage markets will need to be monitored carefully. Forcing companies to separate and sell their retail businesses is ultimately the only way of completely removing risks of discrimination, but selling their retail arm goes beyond what the Cave review recommended and was not considered as an option in our impact assessment. Any other approach to retail competition, whether through legal separation of retailers or the approach Government proposes based around reform of the WSL regime, will require Ofwat to introduce safeguards and monitor market activity closely. Ofwat already has some of the tools in place, with its approach to accounting separation project improving the information available on the costs of different elements of company’s operations.

“Accounting separation will inform our work on market reform. It is also a key part of our future price limits project.”

“The companies are now required to report their costs against nine separately identified parts of their business (‘business units’).”

“The information this should reveal will provide all stakeholders with greater transparency of costs for different parts of water and sewerage service delivery. It should also enable us to challenge and regulate the companies more effectively.”

“Requiring them to prepare separate accounts will help them and others gain a better understanding of the costs and of different activities within each business unit. This could lead to the companies identifying potential new areas of efficiency savings.”

Ofwat Annual Report 2009/2010

4.4 The reforms to increase charging transparency will also help ensure fair access to the market for new entrants and make it easier for customers to switch suppliers. Ofwat will need to reinforce these price focused mechanisms with other controls to tackle non price discrimination. Ofwat's *Future Price Limits*¹¹ consultation includes a proposal to introduce separate retail and wholesale price caps which could help monitor the competitive markets.

“Through our regulation of the wholesale market, we want to:

- *preserve investor confidence, and maintain financeability at a cost of capital that reflects low underlying risk;*
- *reveal better information on which the companies and regulators can act;*
- *find better ways of incentivising:*
 - efficiency in network operation, maintenance and development;*
 - efficiency in resource use; and*
 - innovation;*
- *encourage the development of market mechanisms – in particular to allocate and reveal the value of water; and*
- *support the development of effective and efficient competition at the wholesale level and the retail level (for non-household customers).”*

Future price limits – a consultation on the framework, Ofwat

Increasing upstream competition

5.1 We want to encourage new entrants who wish to provide alternative upstream water supply services under the WSL in order to stimulate a more vibrant wholesale market for alternative water resources and sewerage services and incentivise incumbent water companies to look at alternatives to expensive capital projects in meeting future demand.

¹¹ http://www.ofwat.gov.uk/consultations/prs_web201111fpl

We also want the WSL to allow new entrants to be able to offer specialised services to other new entrants as well as to their own customers.

5.2 We will unbundle the combined licence so that new entrants wishing to provide upstream water supply services, such as inputting their own water resources into a water company's system, will no longer be obliged to provide retail services to its customers. Currently holders of combined licences are required to provide both retail and upstream services to their own customers but nobody else. Removing this barrier from legislation will therefore enable all new entrants to specialise in the services they wish to provide to customers, other licensees or their own premises under a self-supply licence. For example, those with their own water resources will be able to concentrate their efforts on wholesale activities - such as the provision of water resources, treatment and/or disposal services - and leave billing, meter reading and other customer-facing services to other new entrants with the knowhow and resources to provide such services.

5.3 To maximise opportunities for new entrants to provide efficient and innovative wholesale water supply, we will extend their access rights to the water companies' treatment and storage systems rather than just the mains and pipes as is currently the case in the WSL. This will allow alternative suppliers, such as landowners or farmers with spare water, to input water into any part of the network (for example, directly into a reservoir or other storage facility) in order to supply their own customers, other licensees or their own premises under a self-supply licence.

5.4 We will introduce a network licence to enable new entrants to own and operate their own infrastructure (mains, pipes, storage and treatment, etc) which is connected to an incumbent's network and used to provide water supply and sewerage services to its own customers, other new entrants or its own premises.

5.5 In doing this, we will also strengthen the role that the Drinking Water Inspectorate (DWI) has in approving new entrants before they are issued an upstream or network water supply licence or granted an inset appointment. This will be done by naming the DWI as a statutory consultee on the face of primary legislation. We will also give the Environment Agency a similar role in relation to new sewerage licences and relevant insets. The DWI and the Environment Agency will also be consulted on the detail in relevant market codes before they are published to ensure that public health and the environment continue to be protected under the new arrangements.

5.6 Having a range of new entrants on the water supply market will potentially complicate planning for future resources. As is currently the case with licensed water suppliers, all new licensees will be under a duty to provide whatever information a water company may require to prepare its water resource management and drought plans. As is also currently the case, licensees will be statutory consultees in the preparation of these plans.

Reform of the inset regime

“Recommendation 17: In the medium-term I support the replacement of the inset appointment framework with a reformed system for the provision of upstream and infrastructure services. In the interim, however, the Review recommends:

- *the introduction of a framework of access setting out the expectations on*

incumbents and appointees to support the appointment process. This should be binding on all market participants;

- *further streamlining the approval process for new appointments by adopting appropriate regulation: with financial viability determined at both a company and site level as appropriate, standards and prices at a regional level and supply requirements at a site level;*
- *updating the system of developer and water company charges and payments so that developers, appointees and incumbents pay an appropriate share for connection to the network. To ensure non-discrimination, incumbents should offer reference prices based on indicative costs;*
- *allowing companies to specialise in the provision of upstream, infrastructure or retail services, subject to a last resort obligation;*
- *clarifying the unserved requirement. The need for such a requirement should be reviewed periodically;*
- *the introduction of binding common codes and systems for supply to reduce barriers to entry;*
- *reforming the system of supply prices so that an efficient appointee is able to make a fair return whilst also contributing to the local incumbent's supply costs. The supply price should also recognise any structural differences in incumbent's and appointee's costs;*
- *customer should be no worse off than if they were served by the local incumbent over the long-term; and*
- *ensuring the Drinking Water Inspectorate has the powers to check the operational competency of alternative suppliers before appointment, as currently is the case for the water supply licensing regime.*

Independent review of competition and innovation in water markets: final report

6.1 The inset regime has been successful in bringing new and innovative entrants into the water market, predominantly for new developments. The inset appointees have tended to provide multi-utility solutions in a single package along with water and sewerage services. The inset appointees remain as the local water company once end-user customers have moved into the new properties.

Inset appointees

Albion Water Ltd
Independent Water Networks Ltd
Peel Water Networks Ltd
SSE Water Ltd
Veolia Water Projects Ltd

6.2 Developers have choice around the supplier of water and sewerage infrastructure for new developments but are frustrated about the time it can take to negotiate terms for an inset appointee to obtain the necessary connections and negotiate the terms of bulk water supplies and sewerage services with the incumbent water companies. A particular problem has been defining what constitutes an “unserved area” for greenfield sites. As with the WSL regime, we will introduce a requirement for Ofwat to produce statutory market codes and regulated wholesale charges to simplify negotiations and reduce delays to make this market work more effectively. Market codes, which will be enforceable, will spell out what “unserved” means in terms of greenfield sites.

6.3 The Government believes that there is some merit in replacing the inset regime with a suitably adapted WSL for “last mile” infrastructure at some point in the future. This was explored in the upstream impact assessment. Any decision on this will be subject to a full public consultation.

Reform of the special merger regime

“Recommendation 16 of the Cave review: There are potentially significant economic and environmental benefits to be gained from mergers between water companies and, with appropriate safeguard, I believe these benefits can outweigh the loss of a number of the comparators. I therefore recommend:

- raising the qualifying threshold for the special water merger regime to a maximum of £70 million and reforming the threshold so that it applies to the smallest company, as in the wider regime. The UK Government should then keep this threshold under review;*
- Ofwat commissions an independent review of the scope for making greater use of the alternative data sources and statistical techniques and their impact on the loss of a comparator and continues to refine its econometric modelling techniques to take advantage of the information from alternative data sources;*
- Ofwat is given a statutory duty to develop and publish guidance on its approach to assessing the loss of a comparator after consultation with stakeholders. This should set out the criteria, weighting and methodology used in future assessment;*
- Introducing a new first stage test. Based on its published guidance, Ofwat should provide specific advice on a merger to the Office of Fair Trading, including an assessment of the scale of any prejudice. The Office of Fair Trading should consider that advice, as well as any other competition effects arising from the merger and the scope for structural or behavioural remedies, when considering the need for referral to the Competition Commission; and*
- The Government should review the success of the regime after five years.”*

Independent review of competition and innovation in water markets: Final Report

7.1 In most sectors companies are generally free to merge subject to a set of general merger controls which are focussed on protecting and promoting competition in markets. The capital market pressures that these arrangements create can be a strong driver for improving the efficiency of companies leading to lower costs and improved service that can be passed on to customers. At the moment, a merger between two or more water companies must be referred by the Office of Fair Trading (OFT) to the Competition Commission if the turnover of both the acquiring and acquired water company each exceed a threshold of £10m. This creates a significant chilling effect on any potential merger between water companies - limiting capital market pressures.

7.2 The explicit purpose of this regime is to protect a particular approach to regulation that is currently adopted by Ofwat, which, in simple terms, uses comparative information between different companies to identify the best performing 'frontier' company within the sector for certain activities and require the other companies in the sector to improve to meet that level of performance. Following a merger between two water companies the number of comparators available to Ofwat would obviously decrease by one and this could affect Ofwat's ability to undertake this kind of regulatory test.

7.3 In its recent consultation on Future Price Limits Ofwat noted that at an industry level, both operating expenditure and capital expenditure outperformance have reduced over time and in the most recent price review period this complex regime has delivered a 1.6% industry wide operating cost efficiency improvement. This suggests that the effectiveness of the existing comparative regulation regime may be diminishing.

7.4 Furthermore, the Cave review noted that there were both alternative data and techniques available and in use by other regulatory authorities to support a comparative regulatory approach. Adopting these techniques, such as data envelopment analysis, stochastic frontier analysis and benchmarking, or using alternative data, such as sub-company data and comparators from other industries, would allow Ofwat to continue to use comparative regulation effectively but with fewer comparators. This would therefore allow the loosening of the merger regime.

7.5 Not only does the regime protect a regulatory approach which is delivering diminishing returns and which could be delivered by alternative means but it also restricts the scope for water companies to be taken over by more efficient operators and any benefits that might be derived from this.

7.6 We are strongly minded to use a future Water Bill to reform this regime, but will be consulting further with water companies and others to inform a decision on a higher £70m threshold to exclude more mergers from automatic referral to the Competition Commission. The Cave review recommended a £70 million threshold because it is one of the thresholds used in the wider merger regime. It would also capture most of the water-only companies. We will be carrying out a short technical consultation and engaging with stakeholders to improve the evidence base to support this reform.

7.7 There is a much stronger case for reducing uncertainty and burdens around mergers that meet the threshold referral test. We intend to use a future Water Bill to introduce a two-tier referral system, allowing water companies seeking to takeover another water company to offer undertakings in lieu rather than have the automatic referral to the Competition Commission which is currently the case. This change would also bring the special merger regime into line with the wider merger regime where the OFT can remedy competition concerns through conditions rather than make a reference to the Competition Commission. Such conditions might include continuing with separate price controls or

divesting part of the business. In order to help increase transparency, we will require Ofwat to publish its methodology on how it values individual comparators in its comparative regulation regime to help acquiring water companies understand what undertakings it may be required to make when seeking to takeover a comparator.

7.8 We will also be exempting inset appointees that are not subject to the comparative regulation regime. In increasing the threshold and exempting inset appointees, mergers not eligible to referral under the special merger regime (including mergers between and with new entrant licensees) may still be referred by the OFT to the Competition Commission for an assessment under the size of market test in the ordinary merger regime (e.g. if an actual or potential merger will result in the merged entity controlling 25% or more of a defined market). The OFT may refer such a merger where it considers that it may lead to a significant lessening of competition.

7.9 BIS has consulted on a number of reforms to the wider merger regime as established under the Enterprise Act 2002. Where appropriate, these will be adopted for the special merger regime in order to ensure consistency.

“The Government regards the merger regime as one of the key strengths of the UK competition regime, but considers that there is further scope for improvement by addressing the disadvantages of the current voluntary notification regime and streamlining the process to support growth, enterprise and consumer welfare.

The Government is seeking views on:

- *Options to address the disadvantages of the current voluntary notification regime. These are the risk of missing anti-competitive mergers, and the difficulties of applying appropriate remedies to completed anti-competitive mergers.*
- *Measures to streamline the regime by reducing timescales and strengthening information gathering powers.*
- *Introduction of an exemption from merger control for transactions involving small businesses under either a mandatory or voluntary notification regime.”*

A competition regime for growth: a consultation on options for reform, Department of Business Innovation & Skills

Ofwat regulation

8.1 Successful delivery of the Government’s objectives for increasing competition in the water sector is only possible if the reform package follows through into Ofwat’s regulation of the water sector. Ofwat’s proposals in its *Future Price Limits* consultation would complement this package by increasing incentives for companies to consider the customer facing end of their business by introducing a separate retail price cap, while the network plus sub cap they propose within the wholesale price cap would enable the setting of transparent access prices. Ofwat’s monitoring and regulation of the new

expanded retail market for non-household customers will also be critical to ensuring fair and transparent access for new entrants.

8.2 The Government's strategic policy statement to Ofwat will reinforce the strong steer in the Water White Paper on the Government's objectives on competition, and how these should be balanced against the priorities of maintaining a stable regulatory environment attractive to investors and the strengths of the current industry structure. Revised social and environmental guidance to Ofwat will outline the Government's priorities in these areas to help water companies prepare their business plans for the forthcoming price review. In addition there will also be a revised statement of obligations to provide clarity around the water companies' statutory duties.

8.3 The Welsh Government will be publishing a water policy statement in the New Year to outline its objectives for the sector within its jurisdiction. We are going to ask Ofwat to consider the way it regulates merged English and Welsh water companies (should this happen under a reformed special merger regime) and inset appointees that operate in both England and Wales. This is with a view to ensuring that Welsh Ministers will continue to regulate the areas currently served by Welsh Water, Dee Valley Water and Albion Water in North Wales and any future inset appointments that may be granted in Wales.

Protecting customers

9.1 We need to ensure that customers are protected from any abuse of the new competitive markets for non-household customers. We support Ofwat's proposals to set default tariffs for retail charges to non-household customers. These, combined with minimum service standards, will help ensure that customers that decide to switch will at least be no worse off than if they decided to stay with an incumbent water company.

"We consider that the default tariff is the best option in the contestable market. It strikes the most appropriate balance between ensuring that customers are adequately protected and allowing companies the freedom to explore new ways to offer services to those customers. The companies would retain a share of the financial benefits – possibly all of them – from creating new service or tariff offerings outside the default tariff that customers were willing to pay for. Where there are actual or potential entrants in the contestable market, this competitive pressure would add to the incentives for the existing retailer to innovate."

"We also consider that if the companies had to start offering tariffs at a price below the level of the default tariff because of competition from entrants, then the retailer would have to bear the loss of that revenue. This is in line with our general policy of not remunerating the companies for revenue lost through competition. It would also drive them to look for innovative ways to reduce costs. When effective competition has developed, we would consider whether we need to continue with any retail controls in the contestable market."

"Given the UK Government's announcement to reduce the threshold where non-household customers can choose to switch supplier, we will consider what additional protection we may need to provide for small and medium-sized enterprises while effective competition develops."

Future price limits – a consultation on the framework , Ofwat

9.2 Legislation will require Ofwat to produce the first statutory code of practice on mis-selling for a utility market. This will in particular protect small and medium sized businesses from becoming worse off because of a decision to switch suppliers and will cover contracts that have resulted from online sales, cold calling and doorstep sales.

9.3 As with other sectors, we will ask Ofwat to introduce a mandatory “cooling off” period in the code of practice for those customers that consider switching suppliers but subsequently change their mind. For example, in some markets there is a period of between seven to 14 days in which to cancel a switching application.

9.4 Guaranteed service standards (GSS), which have set minimum customer service standards in the sector for some time, will be extended to licensed water suppliers and new entrant sewerage service providers. This will involve Ofwat, having carried out a public consultation, asking ministers to put into legislation new or revised standards applicable to the competitive market. The last Government did not introduce this requirement for licensed water suppliers because it was expected that eligible customers would be in a better position to agree customer service standards through contract negotiations. However, this may not be the case once the competitive market is extended to all non-household customers and there could be issues if some standards make incumbent’s less competitive than new entrants. The GSS will continue to ensure minimum standards of service for all customers, but our expectations are that increased competition will incentivise incumbents and new entrants to provide higher levels of customer standards than those laid down by Government.

9.5 We will legislate in a future Water Bill to improve the statutory enforcement regime so that Ofwat has the powers it needs to gather information from water companies about compliance with GSS. We will also allow financial penalties to be applied to water companies and WSL licensees for infringements over a five year period. These measures were consulted upon by the last Government and were endorsed by David Gray.

“Water companies have a duty to meet their statutory obligations and to comply with conditions set out in their appointment. Where they fail to meet these obligations Ofwat can take enforcement action.

Ofwat has a power to require information from a company that is or may be breaching its obligations. At present Ofwat’s power does not extend to information where a company may be failing to achieve the minimum standards of performance set out in the Guaranteed Service Standards.

In the draft Flood and Water Management Bill the UK Government proposed to extend the power to require information to ensure that the regulator and Ministers could seek information from companies where they have failed or are failing to achieve any Guaranteed Service Standards, which would also include any adopted for services to developers and those requesting a connection (see above).

“The draft Bill also proposed extending the time limit for imposing a financial penalty from one year to five years, to fully reflect the duration of the contravention and the full extent of any detriment to customers that has occurred across a price review period”.

“Recommendation 9 of the Ofwat review: At the next legislative opportunity, Government should enact the changes to Ofwat’s enforcement powers proposed in the draft Flood and Water Management Bill.”

Review of Ofwat and consumer representation in the water sector