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Dear Mr Ryman

## **DETR REVIEW OF COMPETITION**

Thank you for the opportunity to comment on DETR's consultation paper *Competition in the Water Industry in England and Wales*. The paper makes a comprehensive and valuable contribution to the debate about competition in the water industry. This letter sets out our main comments and Annex 1 provides a more detailed response to the questions raised in the consultation. The Director has endorsed the views in this letter.

### **1. Key policy objectives**

We agree with your view that competition is desirable, as it should reduce prices, increase efficiencies, stimulate innovation and better use of resources and benefit customers. Competition between suppliers for customers stimulates those suppliers to reduce costs and prices and improve service standards. The introduction of large user tariffs has demonstrated that the threat of customers having a choice of supply can provide real benefits to those customers.

With regard to safeguarding public health and the environment, we share the Government's desire to make sure that the public health and the environment are not jeopardised. We have always maintained that these are issues to be considered and resolved and are not a fundamental impediment to greater competition. In February this year, the Drinking Water Inspectorate (DWI) issued guidance on the subject of maintaining drinking water quality in common carriage arrangements. Providing the guidance is followed, the DWI does not believe quality should be a barrier to common carriage arrangements. Furthermore, the DWI has set out how it envisages it will regulate common carriage arrangements between water undertakers and water suppliers not licensed under the Water Industry Act 1991 (WIA91).

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Greater market competition must not lead to lower standards of service. In particular, it is important that customers continue to receive water and sewerage services and the restriction on the disconnection of households, introduced by the Water Industry Act 1999, reinforces this view. It is important that there is a level playing field between incumbents and new entrants, in terms of protecting customers (particularly households).

Incumbents and their remaining customers should not be made to finance the entry of competitors to the market, but nor should incumbents be allowed to frustrate entry by setting unreasonable terms, for example, for common carriage. In the short term, the entrant and its customers would pay the appropriate proportion of the direct costs of operating existing infrastructure and the full costs of installing any new infrastructure needed. In the longer term, more competition should lead to greater efficiencies and lower costs overall. Incumbent companies should not use the common carriage application process as a way of gaining revenue above a proper amount for covering the costs of administering applications. Charging for processing applications should not be used as a deterrent to entry.

The question whether some aspects of the provision of water and sewerage services should be guaranteed by each statutory undertaker for its area needs careful consideration. We must be careful not to stifle the growth of competition by introducing new statutory obligations on companies. It is also important that a level playing field exists between incumbents and new entrants. In this regard, new licensing arrangements could be helpful.

## **2. New licence arrangements**

Much attention has been given to whether companies that are not licensed under the WIA91 should be allowed to take part in common carriage. We believe the framework is already in place, through the Competition Act 1998 (CA98). The companies have to comply with CA98, which prohibits a company from abusing a dominant position. Refusal to allow another potential provider of services access to that company's essential facility on reasonable terms could constitute such an abuse. It may be unreasonable for an incumbent to insist that a common carriage company be licensed, even if it assists that company to achieve that status.

Nevertheless, some modest changes to the existing legislation could accelerate the move towards competition, for the long term benefit of all customers. For example, a new and simple licence for common carriage companies (whether these are statutory undertakers operating outside of their areas of appointment or new entrants) could be helpful. It would extend the remit of the Drinking Water Inspectorate to cover the quality of water provided by all suppliers, not just existing statutory undertakers, using the public network.

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An important question still to be addressed is whether suppliers who provide only the customer-related elements of the service (billing and customer-interface) need to be licensed. There may be a case for another type of licence purely for companies who wish to provide only customer-related services. This licence might not need to contain as many conditions or duties as the statutory licence.

We would welcome the opportunity to work with you to consider these issues further and to develop some firm proposals. Arrangements for new licences should, however, focus on the need to safeguard water quality and provide protection to vulnerable customers.

Furthermore, the development of common carriage under CA98 should not be hindered by consideration of a new licence for common carriage. It is important that undertakers do not see the possibility of new legislation as a reason to delay the progress of competition. New legislation should also allow every non-licensed common carriage company to become licensed quickly, once the new framework was put in place.

### **3. Abstraction licence trading**

Competition in the water industry would greatly be facilitated if the arrangements for granting, revoking and transferring abstraction licences were liberalised, so that there could be a competitive market in the raw material. The recent DETR consultation paper *Economic Instruments in Relation to Water Abstraction* is an important milestone in that respect. We will send a formal response to the document in due course, but we welcome the positive approach it takes towards trading. We are keen for the proposals in the consultation paper to be taken forward quickly.

The suggestion in paragraph 6.8 of that paper, to provide the Director General with the power to transfer abstraction licences between companies on competition grounds, needs to be seen against the background of trading. Once trading is established, the market should, subject to environmental constraints, provide the best mechanism for ensuring that licences are allocated where they are valued most. However, companies may be able to establish a dominant position in local markets for abstraction licences, and to abuse that position by hoarding abstraction licences. Consequently, we would welcome this additional power to deal with such abuses, in conjunction with the Director's powers under CA98.

Yours sincerely

**Beryl Brown**  
**Head of Competition Policy**

## **ANNEX 1 - OFWAT'S RESPONSE TO DETR REVIEW OF COMPETITION**

**Q1. The Government wishes to ensure that health, environmental and social objectives are not put at risk. How are these objectives best safeguarded in the light of increased competition? (paragraphs 4.1-4.9)**

See main letter.

**Q2. Which statutory duties covered by this section should be underwritten by the existing statutory undertaker? (paragraphs 4.8-4.9)**

See main letter.

**Q3. How should voluntary agreements and codes of practice accepted by existing companies be dealt with if and when new companies enter the industry? (paragraph 4.9)**

See main letter.

**Q4. How should the costs and benefits of competition be assessed? What is the fairest way of meeting the costs? (paragraph 4.10)**

See main letter.

**Q5. How can the Government maximise the degree to which the (longer term) benefits of increased competition outweigh the (short-term) costs of change? (paragraph 4.10)**

If competition is allowed to develop according to how the market dictates, rather than restricted to a set path, then the benefits should be maximised without the need for Government intervention. Incumbents and their remaining customers should not be made to finance the entry of competitors to the market, but nor should incumbents be allowed to frustrate entry by setting unreasonable terms, for example, for common carriage. In the short term, the entrant and its customers would pay the appropriate proportion of the direct costs of operating existing infrastructure and the full costs of installing any new infrastructure needed. In the longer term, more competition should lead to greater efficiencies and lower costs overall. Companies can help to minimise the short-term costs of change by adopting appropriate pricing policies.

The issue of the incumbent suffering partially or wholly stranded assets may arise in some circumstances, although Ofwat does not anticipate this to be significant. Where there is a significant risk of stranded assets as a result of common carriage, efficient companies will seek alternative uses for those assets. Where no alternative use is found, it may be appropriate to charge an access price that reflects the costs of stranding. Access prices set on this basis would, however, be subject to close scrutiny by Ofwat to establish the robustness of companies' estimates of the costs of stranding. Moreover, such an approach to access pricing should not be allowed to deter entry that would reduce costs over the longer term.

**Q6. Are any changes to the Mogden formula necessary to encourage the development of an alternative market in pre-treatment and disposal of sewerage? (paragraphs 5.21-5.23)**

There is a significant amount of competition in the provision of sewerage services, such as the use of on-site treatment and cleaner technologies, which do not rely on the public sewerage system. The market for on-site industrial treatment is relatively mature and worth approximately £100m per annum in the UK. There are many technology suppliers, consultants and contractors that operate in this market. The cleaner technology market continues to grow.

None of the existing companies asked Ofwat to discuss changes to the Mogden formula, in this year's approval of charges schemes process. We believe the formula could be reviewed from time to time, but until there is something better to replace it, it remains a flexible and fair method to calculate effluent charges. The components of the formula reflect the main cost drivers - collection, primary/volumetric treatment, biological treatment and sludge management.

There may be a case, however, for improving the way in which the Mogden formula deals with specific pollutants such as metals, colour, xenobiotics and recalcitrant organics. In some cases, like industrial sectors, it could also be appropriate to use assumed strengths, in order to reduce monitoring costs. In some areas, the formula is being developed for use by non-traders, such as hospitals.

**a. What suggestions do respondents have for a new charging basis to replace the Mogden formula?**

None.

**b. If a new formula or equivalent could be agreed, how would it best be brought into effect? For example, should it be enforced through the new provisions for charges schemes in the Water Industry Act 1999?**

We do not believe there is a need for a new formula. If one was proposed, however, the sewerage companies should be allowed to choose how to charge for effluent reception, conveyance and treatment. There is provision for the Director General to approve companies' charges schemes, who would judge whether companies were charging in an appropriate manner. There is also provision under the WIA91 for companies to charge non-household customers by agreement.

**c. How would the transition to any new charging basis be managed fairly for all customers?**

We do not see that there will be a move to a new charging process. However, all companies have to manage the introduction of new tariffs and the Director will ensure there is no undue discrimination or undue preference through his enforcement of Licence Condition E and his power to approve charges schemes.

**Q7. Is there an effective market operating in sewage pre-treatment and alternative disposal arrangements or are there obstacles to the development of**

**such a market? (paragraph 5.23). If so, how might these be overcome, and can this be done without legislative change?**

See our answer to question 6, above.

**Q8. Is there a case for an explicit power of compulsory abstraction licence transfer where the Director General considers it necessary on competition grounds? (paragraphs 6.5-6.8)**

There is a case for the Director General to be given an explicit power to compel companies to share or transfer resources, especially where the current licences have not been allocated as a result of any competitive process. This explicit power would maintain consistency with the Director's current powers under section 40 of the WIA91 to compel companies to make and receive bulk supplies.

This explicit power would also complement the provisions of the Competition Act 1998 (CA98) which allows the Director to decide whether an incumbent's refusal to share access to resources is unreasonable, but not to set the terms on which access must be shared, if an infringement is found.

The Director's decisions should be subject to appeal. Where the issue is the introduction of competition, then that appeal could be to the Competition Commission Appeal Tribunal. DETR might wish to accord to the Environment Agency (and possibly the DWI) a special status, as consultee or interested party. Where there is an issue with environmental implications, particularly decisions about sharing access to resources, the Director has said that he will consult the Agency about the most appropriate solution, before making any decision. We will provide more detailed comments in our response to the consultation paper *Economic Instruments for Water Abstraction*.

**Q9. Is further Government action required to encourage more bulk supplies? (paragraphs 6.9-6.11)**

It is not clear what further action the Government is proposing. The Director already has powers under the WIA91 to compel companies to give and receive bulk supplies, if asked to do so. We believe the current system is sufficient.

**a. If so, what changes to the existing regime would respondents like to see?**

None.

**b. Are engineering and water quality considerations likely to prove significant obstacles?**

Not applicable.

**Q10. Do respondents agree with the Government's proposal that inset appointments should be permitted for co-located premises that together exceed the threshold? (paragraph 6.15)**

Yes. The current criterion in section 7(4)(bb) of the WIA91 requires that each premises are supplied with at least 250MI per year. Allowing the aggregation of

consumption at each customer's premises on the same site would increase the availability of inset appointments. It is important to define what is meant by the term 'co-located'. Co-located premises should have a link by common infrastructure, and by ownership, purpose, or by common consensus by adjacent customers.

We believe the example in the paper of an industrial estate already qualifies for an inset appointment under section 7(4)(bb).

**a. Water companies are specifically asked to identify in their response how many customers within their area might be able to benefit from such an arrangement.**

Not applicable.

**Q11. Do respondents have views on making specific provision for a franchise approach [time limits] to inset appointments, including the arrangements that should be put in place for the end of the specified period? Should all insets be time limited? If so, should the time limit be prescribed or subject to negotiation on a case by case basis? (paragraphs 6.16-6.17)**

The Director has created two successful time-limited inset appointments already (MoD Tidworth and Shotton Paper). Before the insets were granted, the new Appointee gave its consent under section 7(4)(a) of the WIA91 to being replaced in defined circumstances. A third inset appointment is proceeding on this basis also.

There is a case for giving the Director a more direct method by which new appointments could be terminated, in appropriate circumstances. It may not be necessary or desirable to create a mechanism by which all inset appointments are automatically limited to a specified timescale. This could disrupt incentives in the closing stages of the 'franchise', for example by skewing the pattern of investment. If the 'franchise' period was too short, the franchisee may have an incentive to avoid investment or necessary expenditure on maintenance thus leaving an incomer with higher than expected costs.

One important issue to consider is the ownership of assets, and how these might be transferred from the outgoing to the incoming undertaker. Assets are currently vested in undertakers, rather than being owned by them. A condition of becoming an undertaker might be that, if it loses out to another company in managing the 'franchise', it leaves the assets in at least as good a state as when it took them over.

**Q12. Are there any other improvements that respondents can suggest to increase the effectiveness of the inset appointment system? (paragraphs 6.12-6.17)**

The DETR has already agreed to the lowering of the large-user threshold, although we do not know the timetable for this change. There is a case for a further reduction to be made after one or two years, in a similar manner to the stepped changes made in the electricity industry. Further changes to the large user threshold can be made without primary legislation. Alternatively, the Director could be given the power to set a new threshold.

Beyond that, the categories of inset (greenfield and large user) could be extended to include, for example, the whole or part of a local authority's area, or for a defined zone on the incumbent's distribution system.

Access to resources is important to the success of inset appointments. Negotiations over bulk supplies from the incumbent to the potential inset appointee can slow down the application process considerably. Changes in the abstraction licensing regime, including the potential new power for the Director to transfer licences on competition grounds, and the introduction of common carriage will be helpful in this respect.

**Q13. Do respondents agree that undertakers should have a duty to provide supplies across their borders on demand to non-domestic users? (paragraphs 6.18-6.19)**

Yes, although the water is provided for non-domestic *purposes*. This would make it consistent with the current duties to provide connections for water for domestic purposes and for connections to public sewers.

**Q14. Do respondents agree that the geographic restrictions on seeking consent for the discharge of trade effluent should be removed? (paragraph 6.19)**

Yes, as it would maintain consistency with other changes to remove geographical restrictions on cross-border connections (see question 13).

**Q15. Do respondents agree with the Government's opinion that it is preferable to start with common carriage relating principally only to services for larger commercial and industrial users? If so, at what level should the initial threshold be set? (paragraph 7.6)**

No. Ofwat believes that the Competition Act 1998 (CA98) does not preclude anybody from the benefits of common carriage.

Furthermore, it is not clear why Ministers propose to deny domestic customers the benefits of competition. The main issue referred to by paragraph 7.6 of the consultation document is of safeguarding public health. Given that water is mixed in the pipe network before it reaches all groups of customers, excluding domestic customers from common carriage on public health grounds would not prevent the mixed water from reaching their taps. It is better to put in place the framework for common carriage, and let the market decide how it should develop.

Ofwat believes common carriage is already available under CA98. Any new law, which stated that common carriage was only available to large users, could be interpreted as limiting the scope for common carriage through CA98.

**Q16. What controls need to be established and operated to ensure that public health considerations are safeguarded? (paragraphs 7.12-7.17)**

All of the existing water companies are working on producing access codes that will govern the shared use of their networks by common carriage companies. These codes should set out the technical and operational characteristics that new entrants

will be required to meet before access is allowed. These terms of access will be based upon the incumbent company's own operational standards, and will be designed to ensure that water quality is not jeopardised by common carriage and that public health is safeguarded. There will be an agreed monitoring and sampling regime to ensure public health continues to be safeguarded.

The Drinking Water Inspectorate has produced a guideline on the quality aspects of common carriage. The DWI believes that, if the companies involved follow the guideline, water quality should not be a barrier to common carriage.

**Q17. What are the implications for ensuring within common carriage arrangements that both fluoridated and non-fluoridated water zones are maintained? (paragraph 7.13)**

**a. What controls might be needed to ensure that levels of fluoridation are correct?**

**b. Who might set and monitor these levels, and what recourse should there be if they are breached?**

Only some of the entrant's customers are likely to be situated near the point where water is introduced to the network. Where there is a physical link between the input point and the customers, many of the incumbent's customers could be affected. The incomer's water is likely to be received by some of the incumbent's customers, as well as its own. Therefore, the new company would need to provide water meeting the appropriate requirements to all those customers that actually received its water.

In particular, the incoming water would need to comply with the requirements of the local health authority in the area to which the water is physically supplied. The incumbent water company would already have a barrier to stop significant mixing between fluoridated and unfluoridated water supply zones. If an incumbent's water is entering one zone and its customers are on the other side of the physical barrier, the incumbent might have to change the supply arrangements.

**Q18. How should plumbosolvency and similar problems be controlled? (paragraph 7.14)**

Similar to the question of fluoridation, the issue of plumbosolvency requires the new entrant's water to comply with the new Drinking Water Quality Regulations implementing the new EC Drinking Water Directive, and to be compatible to the water that already flows in the network.

It should be a requirement that the incomer bears the cost of suitable and compatible plumbosolvency control. This is a necessary part of complying with the Drinking Water Quality Regulations for the general water supply. It may be necessary for pilot tests to be carried out on the plumbosolvency of the incomer's water and indeed of mixed waters. It would be for both companies to agree on the procedure for carrying out these tests. It is reasonable to expect the costs of such tests to be borne by the new water company rather than be a burden on the incumbent's customers.

**Q19. Are there any other technical or hydraulic issues that need to be addressed?**

Ofwat believes there are no insurmountable issues. Many of the operational aspects of common carriage are already carried out by companies in the treatment and transport operations that they carry out within their own areas. They already hold the experience and knowledge required to implement common carriage access to their networks, or as an entrant to another company's network. An important issue to manage is the flow rate of the incomer's supply, to ensure the customers local to the input point (who may not solely be the incomer's customers) are not affected.

**Q20. Is legislation needed to ensure that liability arrangements for supplying water unfit for human consumption are fair? Should it be possible for a criminal prosecution to be made against a company other than the statutory undertaker and, if so, what provisions would be required? (paragraph 7.17)**

The concept of a common carriage licence includes provision for criminal liability, similar to that which undertakers bear. The DWI has produced guidance on how it will regulate the quality aspects of common carriage, including its views on which company holds responsibility in the event of a quality incident.

**Q21. How could the current system of averaging prices within regions best be maintained given the introduction of new suppliers? (paragraphs 7.18-7.22)**

The current pricing system already incorporates examples of de-averaged tariffs. In general, charges are averaged across a company's region but de-averaged according to customer size. Where companies have merged, however, charges within a given customer class may also vary by location. For example, metered household customers of Dee Valley Water pay different charges for water depending on whether they live in Wrexham or Chester.

This system does not necessarily need to be maintained in perpetuity. As competition develops, companies may wish to go further by bringing their tariff structures more closely into line with local costs. Whatever the companies choose to do, they should remain consistent with their current charging policies. Any de-averaging would also have to be consistent with the Director's duty to protect the interests of customers, particularly those in rural areas. That might be achieved by imposing limits on regional differentials, for example, or maintaining a standard price to some groups of customers irrespective of where they live, as used in the electricity sector. Moreover, de-averaging could be phased in order to ameliorate its impact.

The idea of a universal service obligation, as mooted and rejected by Ofwat, would need to be assessed alongside other social policy tools on the basis of the costs and benefits of achieving a clearly defined social objective.

**Q22. Is there any evidence available on the scale of cost differentials between customers within regions? (paragraph 7.20)**

There has been no evidence of this presented to Ofwat. If a company approaches Ofwat with evidence of cost differentials, the Director will consider the matter with regard to his duty to protect the interests of customers, especially those in rural areas. See question 21 above, for more details.

**Q23. If competition were to be extended to domestic consumers, how could the charging issues discussed in paragraph 7.22 best be addressed?**

As we said above at question 15, Ofwat believes that competition already applies to domestic customers. We do not believe that metering is an absolute necessity to allow domestic customers to benefit from competition. There are several ways of charging for water, including the use of rateable values and on the basis of estimated consumption, and it is for the incumbent and new company to agree the most appropriate method.

**Q24. How should arrangements for the physical access to the system by third parties best be defined? (paragraphs 7.23-7.24)**

All of the existing water companies are working on producing access codes that will set out the terms and conditions that will govern access to their networks. The physical arrangements for access will be based on their existing connection practices and will be subject to negotiation and contractual agreement between them and the potential entrants.

We believe it is sensible for the network owner to retain operational control of the network, in order to manage the input of new water into the existing system. In this way, the network operator can optimise the potential impact on water flows and pressure.

In some cases, connection to the network could require the incumbent to reinforce its network to cope with the new flows. This raises issues regarding the scope and level of the charges the new entrant will have to pay. As far as possible, the direct costs of competition should be borne by the new entrant and its customers, not the incumbent's customers. Similar issues currently arise in relation to connections to the network for new developments/customers. It would appear appropriate for the scope of common carriage connection costs to be treated in a manner consistent with the provisions of section 43(4) of the WIA91 for requisitioned water mains.

The Director believes that new entrants would be best protected against excessive charges, and delays arising from disputes, if he had power to determine disputes about the level and scope of such charges.

Consistent with this, the Director believes that a similar power to determine disputes about the charges levied for mains and sewer requisitions would provide more effective protection for customers, and should be introduced through the proposed Water Bill. There is provision under section 42(6) for disputes between a water undertaker and any other person regarding the charges levied for mains requisitions to be referred to arbitration by someone appointed by the President of the Institution of Civil Engineers. Similar provisions relating to sewers are contained in section 99(6). Experience suggests that the arbitration process may not constrain undertakers from seeking to recover costs beyond those reasonably incurred in complying with the requisition. The power for the Director to determine disputes would provide such a constraint.

Ofwat is currently exploring how the operation of existing provisions on requisitions and the adoption of new infrastructure on new developments may be addressed through the use of CA98 and existing WIA91 powers. It is also considering whether any changes in legislation (in addition to the proposal for the Director's power to

determine requisition disputes) are needed to open up this market to competition and maximise choice for customers.

**a. Can this be arranged by mutual consent, or is a formal common access agreement required?**

A formal common agreement is unlikely to cover all of the factors that every individual company will require. It is better to leave the parties involved in each access case to agree the arrangements depending on the specific characteristics of the case.

**b. If the latter, who should be responsible for setting its terms and on what basis?**

See above.

**c. How much of this should be set out in legislation?**

To the extent that the Director could be given new powers to determine disputes, this power could be set out in statute.

**Q25. How should a system of dispute resolution work? (paragraph 7.25)**

If two parties cannot agree on terms for common carriage, the Director can judge whether the incumbent's behaviour infringes CA98. Under CA98, the Director's decision is subject to appeal to the Competition Commission's Appeal Tribunal. Where there is a dispute about costs of reinforcement, the dispute could be resolved by the Director under his proposed new powers. See question 8, above.

In the event that the parties to an agreement cannot resolve a dispute after terms have been agreed, it seems sensible for the common carriage contract to contain a mechanism to resolve disputes. The parties should agree to accept the decision of an independent arbitrator. The resolution of disputes by such an arbitrator does not fetter the Director's ability to investigate potential abuses by the incumbent of a dominant position, or other anti-competitive behaviour. Alternatively, if the Director was expressly required to settle common carriage disputes, they could be designated under section 30A of the WIA91.

**a. What measures are needed, if any, to ensure that any disputes are resolved systematically, fairly and within an acceptable time-frame?**

See question 25 above.

**b. Who should meet the costs of dispute resolution? Should it be the potential incoming company; both the incoming company and the company owning the pipes (in which case, how should the costs be allocated); or should costs be met through some other means?**

If the Director General is required to investigate a complaint under CA98, the costs of such an investigation are to be met by Ofwat's budget, which is collected through water companies' licences. If all parties to a common carriage arrangement are to be licensed, then all companies will contribute to Ofwat's budget. If disputes were

designated under section 30A of the WIA91, the Director could recover from the parties to the dispute. This is preferable.

**c. How much of this (if any) needs to be addressed in legislation?**

See question 25 above, about jurisdiction and cost recovery.

**Q26. Is it appropriate to pursue common carriage for sewage? If so, what issues additional to those for the common carriage of water should be considered? Which water-related issues are irrelevant for sewage? (paragraph 7.26)**

There is already provision within section 110A of the WIA91 for one undertaker to use another's sewerage network (including treatment and disposal assets). This mechanism has already been used to support several inset appointment applications. As set out above (see question 15) CA98 does not preclude any group of customers from common carriage. This principle applies to the provision of sewerage services in the same way as it applies for water services.

Common carriage of sewage does not raise the issue of safeguarding public health in the same way as it does for water, simply by virtue of the fact that common carriage happens after effluent leaves customers' premises.

There are still issues to address. For example, where competitors set up their own treatment facilities, measures would be needed to ensure that each company extracted the appropriate volume and strength of effluent for treatment from a sewerage system being used for common carriage. Also, the Environment Agency's views should be sought on pollution control and discharge consent issues, in cases where a single catchment drains to treatment works vested in different companies. There are also issues relating to liability for pollution incidents.

In terms of disputes resolution and costs of network reinforcement, similar considerations may apply for new entrants connecting to the sewerage network as for water. See question 24 above.

**Q27. Do respondents agree that it would be desirable to have a single national framework for network codes? (paragraph 7.27)**

No. All of the water and sewerage companies and water only companies have already made significant progress in developing access codes. They have prepared statements of the principles that would govern the shared use of their assets and these have been drawn up after discussions between themselves on common areas of interest. While there is a degree of commonality in the companies' work, each company has added its own provisions to suit its circumstances. This suggests that the companies themselves do not want to be tied to a single, common code. It also demonstrates that comparative competition between companies will encourage best practice to emerge.

**Q28. If so, what action is needed to ensure that a common network code for water and, if appropriate, for sewage is developed across the industry that is fair both to incumbent statutory undertakers and those seeking to enter the**

**industry? Should any of this be set out in statute and, if so, what level of detail is necessary? (paragraphs 7.27-7.30)**

There is no need to specify network codes in law. Common carriage access codes should be left to evolve depending on each existing company's experience and challenge by competitors. The regulation of common carriage should be left to the Director General, the Environment Agency and the Drinking Water Inspectorate, subject to appeal.

**Q29. Do respondents consider that customers should be given the right to engage an authorised contractor other than the statutory undertaker to lay all the service pipe between the point where it enters the property and the main and to make the connection to the main? (paragraphs 8.1-8.4)**

Yes. The Director General has advocated the desirability of competition for connection work since 1992. In addition to the issues concerning laying service pipes, customers should be given the right to engage an authorised contractor other than the statutory undertaker to lay mains, subject to meeting reasonable safeguards relating to water quality. While undertakers generally allow contractors to lay mains, it appears that some may be inhibiting competition by creating difficulties for contractors who wish to undertake this work.

Furthermore, contractors and developers pay the whole cost of installing the main and apply to the undertaker to adopt it. Some undertakers pay self-lay contractors an asset value for the new infrastructure on adoption, while others do not. In order to ensure a level basis for competition, similar provisions to the relevant deficit arrangement set out in section 43 of the WIA91 should exist for self-laid infrastructure. The undertaker's payment to the contractor for the asset would then take account of the revenue it would receive from customers served by the main.

**a. If so, how should the system of authorising and registering approved contractors work?**

Authorisation should be left to the water undertaker, subject to appeal to the Director and the Drinking Water Inspectorate. Most undertakers already have processes for evaluating the competence of contractors seeking to work for them, usually with reference to holding of qualifications eg NVQs. Indeed, some companies already have a system for registering approved self-lay contractors.

**b. How should criminal liability for contamination resulting from negligent "tapping-in" be addressed? Who should be responsible for prosecutions?**

The procedure for authorising contractors should include provision for addressing contamination problems that have arisen out of incorrect connections. The most appropriate remedy would be prosecution by DWI, with the right for the water undertaker to claim compensation for remedial costs necessarily incurred (by analogy with the Environment Agency's pollution prosecution powers in the Water Resources Act 1991). The final connection should be made under careful supervision to minimise the risk of contamination.

**c. Who should be responsible for pipework and subsequent liability for street restoration works?**

Irrespective of who lays the pipework when making a connection to the main, customers would usually want the undertaker to 'adopt' or become responsible for that pipework subsequently, as is the case in respect of new sewers. To avoid problems similar to unadopted sewers, new pipes should be laid to adoptable standards and undertakers required to adopt them. While it is reasonable to expect the contractor undertaking the installation of the pipework to be responsible for the reinstatement of the highway in the first place, on transfer of responsibility for pipework, continuing liability for the reinstatement should pass to the undertaker.

**d. Is the fact that only statutory undertakers are able to undertake street works likely to be an obstacle to competition?**

Statutory undertakers are not the only bodies/persons able to undertake streetworks, but the cost of a licence to carry out such works from the local highway authority may be prohibitive for single property (or small development) connections to the main.

The introduction of a system whereby competent contractors may obtain a single licence to carry out reinstatement works generally, rather than site specific, could lower the costs of connections and increase competition between contractors.

**Q30. Is it necessary to introduce a new category of "licensed supplier", so that appointment as a statutory undertaker is not required to enable someone to supply water through the public system? (paragraphs 9.2-9.10)**

No. Ofwat believes common carriage is already available to all providers of water, under CA98, without the need for these providers to hold a licence under the WIA91 or a new form of licence.

However, we believe that an alternative to the statutory appointment could be a useful method by which providers of water and sewerage services across the public network are regulated. It would also continue to protect the interests of customers and give the DWI the power to prosecute both the network owner and the new entrant.

**Q31. If so (paragraphs 9.2-9.10):**

**a. What key powers and obligations should such licence holders be given? (please be as specific as possible)**

The key difference in an alternative, common carriage licence is that it would not be linked to a specific geographic area. We would welcome the opportunity to work with DETR to consider these issues further and to develop some firm proposals. However, the development of common carriage under CA98 should not be hindered by consideration of a new licence for common carriage. Furthermore, it is important that undertakers do not see the possibility of new legislation as a reason to delay the progress of competition. New legislation should also allow every non-licensed common carriage company to become licensed quickly, once the new framework was put in place

An important question still to be addressed is whether suppliers who provide only the customer-related elements of the service (billing and customer-interface) need to be licensed. There may be a case for another type of licence purely for companies who wish to provide only customer-related services. This licence might not need to contain as many conditions or duties as the statutory licence.

**b. The statutory undertaker, who would retain ownership and management of the network, will need to retain liability for maintaining water quality. Should licence holders also be given a criminal liability in respect of providing water unfit for human consumption?**

The common carriage licence holders should be governed, as far as possible, by the Water industry Act 1991. This includes retaining criminal liability for providing unfit water. The Drinking Water Inspectorate's powers of regulation, prosecution and enforcement would need to cover these common carriage licence holders.

**c. How far-reaching should restrictions be on anyone other than statutory undertakers and licensed suppliers?**

In the water industry, unregulated supplies are permitted for all types of customers (ie no licence is required, in any form). There are around 50,000 of these private supplies. There does not appear to be any reason to change the way in which these supplies are regulated.

**d. Do the issues relating to safeguarding supplies require legislation or might they adequately be the subject of requirements written into a network code or contractual arrangements?**

All statutory undertakers have been working on how they would govern the shared use of their networks. Each is preparing an access code that will set out the technical and operational requirements with which all other companies must comply, in order to control the quality and integrity of the whole network. It is sensible for the incumbent to retain operational control of the network and to be able to specify, within reasonable limits, the terms of access, including where access can be granted. There is much to be said for allowing companies to retain the flexibility to respond to changing circumstances and their access codes will be dynamic documents that change over time.

For many of the operational and technical aspects of common carriage, Ofwat expects the existing companies to set out in their access codes how these aspects should be governed. These issues do not require legislation.

The issue of fallback arrangements, both in the short term where there might be technical interruptions to supply (such as burst pipes), and in the longer term when there could be financial or natural supply failures, can also be resolved contractually.

**e. How should the contingent liability on the supplier of last resort be reflected in pricing and in access to water resources?**

Many of the statutory water companies have suggested that the entrant and its customers should choose whether to ask the incumbent to provide a supplier of last resort service. They have argued that this service is not an automatic condition on

them. In these cases, it is for the incumbent to calculate the costs of providing this service and agree with the entrant how the costs should be recovered. Some undertakers already charge for backup supplies.

In some cases, however, particularly when some customers on an integrated network switch supplier (eg households) it is impossible for the incumbent to avoid providing such emergency supplies. In these cases, the entrant might be obliged to pay towards the incumbent's costs.

**f. Do respondents agree that licences should be granted in the first instance only in relation to large customers? If so, does the Government need to set a limit, and if so what should it be?**

See question 15 above.

We recognise that the Government may find it desirable to phase-in the new licence arrangements, starting with larger users, as it would be consistent with the Government's wish for competition to be extended to large users first. However, the current legislative framework does not preclude any group of customer from enjoying the benefits of common carriage. Our discussions with potential new entrants and existing undertakers have shown that they are keen to enter the market for domestic customers. To deny the potential benefits of competition to household and smaller non-household customers needs serious consideration. It also raises the risk that companies who refuse competition initiatives for smaller customers could be infringing the provisions of the CA98.

**g. If licences were to be introduced, would there be a continuing role for the inset appointment process?**

The inset appointment mechanism is currently the only method by which new statutory undertakers can be created. One new water company has already been created in this way. If the inset appointment mechanism was removed, then this could entrench the position of the existing statutory undertakers and deny potential undertakers the ability to compete with them. The scope of the inset process could be broadened, however. See question 12 for more details.

**Q32. Do respondents believe that separately licensing different parts of the water and sewerage industries would be necessary to facilitate effective competition? (paragraph 9.13)**

In the short term, separation is not essential to facilitate effective competition. Already there are new entrants competing to become statutory undertakers, and the existing companies are competing for each other's customers. In the longer term, the separation of functions that are currently vertically integrated could increase the scope for competition further. It could also allow companies to focus on different elements of the service, leading to the emergence of, for example, network companies, supply companies and resource companies. Several companies are already thinking along these lines (eg Kelda, United Utilities and Welsh Water).

**Q33. What are the costs and benefits likely to arise as a result of different forms of restructuring? (paragraphs 9.11-9.13)**

It is difficult to quantify the potential costs and benefits of restructuring. By definition, the benefits from entrepreneurial innovation are impossible to predict accurately. However, the market should be allowed to develop at its own pace, and in so doing it will maximise the potential benefits.

**Q34. Would any such restructuring be desirable for either or both of the water supply and sewerage sides of the industry? (paragraphs 9.11-9.20)**

There could be benefits to both the water and sewerage industries from restructuring of the current vertically integrated functions. As competition develops, innovation will be stimulated and ideas will emerge about how to begin restructuring.

**Q35. If separate licensing were to be adopted (paragraphs 9.11-9.20):**

**a. Would restructuring need to go further than licence separation to achieve the aim of facilitating effective competition?**

Several companies are already thinking how to change their businesses (eg Kelda, United Utilities and Welsh Water). These proposals have been considered without being forced by possible changes to the legislative regime.

**b. What would be the appropriate division(s) to draw between particular activities?**

One split of the functions might be to differentiate between collection and storage, treatment, arterial distribution and local distribution, and supply.

**c. Do any self-contained systems need to be taken into account? (paragraph 9.19)**

There should always be a degree of flexibility retained to deal with cases on an individual basis. In some circumstances, it might be more economic to retain a degree of vertical integration.

**d. What duties, responsibilities and powers should the holders of each category of licence be given?**

There would be a need to ensure that all of the current duties held by statutory companies are apportioned appropriately among the new service providers. This holds particularly for compliance with the quality and environmental regimes.

**e. How would any costs likely to arise as a result of such restructuring best be met?**

If restructuring were required by law, then all an incumbent's customers should contribute to meeting the costs. If it were made permissible, a judgement would be needed about the effect of restructuring costs upon the prices to be charged to those taking advantage of the revised structure, especially entrants accessing common carriage.

**f. How could a framework be established that properly integrated the water quality management issues discussed in paragraph 9.17?**

Whatever form restructuring might take, careful consideration should be given when apportioning duties and responsibilities to ensure that water quality management issues are addressed.

**Q36. Do respondents agree with the Government's view that franchising is an unattractive option for central policy at this stage? (paragraphs 9.21-9.25)**

Recent experience suggests that competitive bidding for the right to continue providing "regulated" activities is not an unattractive commercial opportunity. For so long as quality and environmental performance remain under regulatory control, franchising might be one way of attracting efficient performers. The potential benefits of a franchising system would depend on the term of the franchise and the conditions of its operation.

However, the primary objective of competition in the water industry is to increase benefits to customers by driving service levels up and prices down. Competition between suppliers for the same customers stimulates the companies to be more efficient. In a franchise system, it is difficult to see how customers are given a choice of supply, so the incentives on companies to continue to strive for better and cheaper ways to serve customers are reduced, at least in the shorter term (depending on the length of the franchise term).

**Q37. Comments are invited on the Government's view that, given the current competitive position in the water industry in England and Wales, it is not appropriate at present to dispense with, or modify, the existing special merger provisions, but that this should be kept under review (paragraphs 10.1-10.5).**

We strongly agree that the existing arrangements should be left unchanged, subject to review. We look forward to further consultation in the future as competition develops. Being competitive on an international scale is not the same as being competitive in England and Wales. Leverage abroad must not be gained at the expense of customers at home. We agree that the primary objective of competition in the water industry in England and Wales is to increase benefits to customers. This is supported by the Director's duty to promote the efficient supply of services to customers and the incentives placed upon companies by price limits.

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