



OFWAT FORWARD PROGRAMME 2008-09 TO 2010-11: CONSULTATION DRAFT

Response by Aquavitae (UK) Limited

We are pleased to see the emphasis, particularly in the Chief Executive's overview, on '...developing a framework that will allow effective market competition to develop, delivering consumer benefits through choice and market forces'. We also support the proposal (page 9) for a 'significant new work stream' on competition because, in our view, that is an area in which at present Ofwat appears to lack both resources and expertise. However, we hope that the new work stream proposal does not imply that competition promotion is being treated as a separate activity, because establishing effective regulatory and industry structures that will facilitate and support competition will involve virtually all of Ofwat's work.

Aquavitae has some reservations, based on our experience in the last few years of attempting to enter the large user market, about the extent to which Ofwat will, in practice, promote competition. These reservations have already been expressed in detail in our responses to other consultations, most recently our response to the consultation on 'Setting Price Limits for 2010-15: Framework and Approach' which we provided on January 23. For ease of reference, we summarise them below:

1. Although Ofwat emphasises the benefits of competition in principle, in practice it seems to assume that competition is a long way off. Ofwat's insistence on maintaining its existing access code guidance (which by common consent makes profitable entry impossible) until new legislation is passed, is pushing the onset of a competitive market farther and farther into the future and leading to great uncertainty for potential entrants. Ofwat needs to consider short term as well as long term solutions, given that the Water Act 2003 promised new entrants and customers that, after several false starts since the early 1990s, a framework was at last being put in place that would enable competition to be established.



2. The Chief Executive's overview states that Ofwat '...will develop an appropriate regulatory framework' but we cannot detect any sign that Ofwat has recognised that its approach to regulation, and in particular price controls, will have to change radically with the onset of a competitive market. As explained in our response to 'Setting Price Limits for 2010-15', 'Properly constructed price controls would facilitate the development of competition and allow incumbents to adapt to it in those activities where competition is feasible, whilst effectively regulating (as a surrogate for competition) where natural monopolies exist'.
3. We can also see no indication that Ofwat is taking due account of experience in other utilities where competition has been introduced, and in particular the need for unbundling. In those utilities, unbundling has led to the separation of potentially competitive sectors from natural monopoly networks with the latter becoming separate price-controlled businesses.
4. The consultation on Ofwat's forward programme refers to the need for accounting separation (page 6), which we agree is a very important issue. However, as explained in our response to 'Setting Price Limits: 2010-15', accounting separation is not just a matter of asking incumbents to make their own assessments of what the present costs are of their different activities (as the forward programme consultation seems to suggest). Separation should reveal the costs that would be incurred if each activity were operating as a separate business. To that end, rigorous separation of activities is required, along the lines recommended by the Monopolies and Mergers Commission report on gas in 1993 and subsequently implemented by Ofgas. Aquavitae supplied a note on this issue to the Ofwat Accounting Separation Workshop on January 25.

In general, we would suggest that Ofwat, in its forward programme, should recognise the need to promote competition in the short term, not just regard it as a long term objective. At the same time, it should take advantage of experience in other utilities and begin work on the radical revisions to its approach to regulation that will be required if there is to be competition where it is feasible, and proper control of natural monopoly networks where competition cannot be established.



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