



Ofwat's response to the Cave review's final report on competition and innovation in water markets

Background

1. In March 2008, the Chancellor of the Exchequer, the Secretary of State for Environment, Food and Rural Affairs, and the Welsh Minister for Environment, Sustainability and Housing commissioned an independent review of competition and innovation in water markets. The review, led by Professor Martin Cave, published its final report in April 2009.
2. The Cave review proposed a step-by-step approach to introducing its recommendations, which we support. This will help ensure that reform continues to put customers first and protect their interests.
3. The Government has responded to the final report. Following consultation on their implementation, it intends to bring forward relevant legislative changes in England through the Flood and Water Management Bill.
4. We are developing our approach to implementing these reforms with all of the England and Wales market in mind, having considered particular circumstances in Wales. It will remain for Welsh Ministers to decide how they wish to proceed with the recommendations contained in the final report.
5. This document forms our response to Professor Cave's final report. It builds on our [response](#) to the review's interim report, which we published in January 2009.

Introduction

6. We welcome the Cave review's final report. We believe it represents a valuable contribution to developing reforms that will deliver more sustainable and innovative water and sewerage sectors in England and Wales.
7. The sectors have changed significantly since privatisation in 1989. By 2010, the companies will have invested more than £80 billion to:
 - improve services;
 - increase environmental and drinking water quality; and
 - maintain critical infrastructure.
8. Because of this investment:
 - drinking water quality has improved;
 - leakage levels are 35% lower than they were in the mid-1990s; and
 - the companies' compliance with strict environmental standards is higher.
9. By subjecting the sectors to rigorous independent scrutiny, we have challenged them to improve in order to deliver real benefits for customers. In doing this, we have been able to keep customer bills 30% lower than they would otherwise have been. A litre of tap water delivered and taken away still costs less than a penny.
10. While we can claim success over the last 20 years, the conditions in which we operate are now changing. We face a different set of problems, which require new ideas and flexible responses. In ['Water today, water tomorrow – Ofwat and sustainability'](#), which we published in March 2009, we highlighted a number of major challenges facing the sectors. These include:
 - **Climate change** – latest scenarios (UKCP09) indicate that climate change will alter the seasonal pattern of our weather. Summers will tend to be hotter and drier; winters will tend to milder and wetter. Droughts and floods may become more frequent and more severe, as will their consequences.
 - **Population growth and distribution** – the UK's population is projected to increase over the next few decades, reaching 71 million by 2031. Much of this population growth is likely to be in the water-scarce south-east. This will increase the demand for both water and sewerage services substantially.

- **Lifestyle changes** – the number of single-occupancy households, which use more water per person, is increasing.
- **Consumer expectations** – our 21st-century society means that consumers are becoming more sophisticated and their expectations of the services they use (on aspects such as value or choice) are increasing.
- **Environmental standards** – the Water Framework Directive requires challenging environmental standards to be met.
- **Economic environment** – economic pressures are placing greater emphasis on the need for the UK's businesses to maintain and improve their competitiveness. The ability of businesses to choose and control input prices, including for water and sewerage services, is going to be even more important.

11. Together, these challenges point to pressure on the long-term sustainability of our water resources. The scale, complexity and uncertainty of these challenges mean we cannot continue to rely on doing things in the same way as before.

12. To ensure we all continue to receive the safe and reliable services we expect, we need to change the way we produce, consume and manage these critical services that we rely on each day.

13. The 2007 floods highlighted some of the challenges we will face in the future. Sir Michael Pitt's report and recommendations, published in 2008, were a welcome review of how our society as a whole needs to deal with flood risk in particular.

14. The work we have done since the Pitt review final report, particularly as part of the 2009 price review, will encourage a sensible, phased approach to improving resilience over the long term. This includes considering more sustainable solutions (such as sustainable drainage systems) to meet the needs of consumers and the environment.

15. However, building better and smarter infrastructure is only part of the solution. The companies cannot go on building larger sewers and more reservoirs to meet our demands for these services indefinitely. This is why we welcomed the independent review of charging and metering for water and sewerage services chaired by Anna Walker.

16. We believe that consumers need a fairer and more transparent system of charging that rewards them for managing their use of services. At the same time, we need pricing that sends clearer signals to water and sewerage companies about planning and delivering services in the most sustainable way possible. We look forward to the Walker review interim report and continuing to contribute to this important work.
17. But the most important change we need collectively to make is to manage water sustainably. This includes everything from planning to charging, from water abstraction to sewage disposal. While the current regulatory system has delivered much over the last two decades, it will need to deliver even more over the next 20 years and beyond. That is why we believe that harnessing market forces can have a significant impact on how successfully we meet future challenges.
18. Addressing these issues successfully and efficiently will require substantial investment over the next few decades. The need to match supply and demand will drive a substantial proportion of that investment. This requires a more flexible approach; regulation will need to evolve and adapt. A greater use of market mechanisms alongside other forms of regulation will enable the sectors to meet these challenges.
19. We welcome the valuable contribution that the Cave review has made to developing the reforms needed to establish a sustainable future for the sectors. The report highlights the unparalleled ability of markets to allocate scarce water resources efficiently. It also sets out a vision for the application of market mechanisms to deliver solutions to the complex economic, social and environmental challenges the sectors face.
20. Water bills currently reflect the costs of, among other activities, abstraction, treatment and distribution, while the water itself is generally accorded no value. This is based on the assumption of a limitless water supply.
21. However, the changes to our climate, as well as existing scarcity, undermine this assumption. Increasing demand and declining resources emphasise the urgency with which the inherent value of water must be recognised. The Cave review describes the manner in which market mechanisms may be used to reveal such a value.

22. Collecting, treating and transporting water and sewage accounts for up to 90% of the value of the sectors. These areas also account for almost all of the companies' environmental impact. Such upstream activities present a significant opportunity for efficiency gains to produce substantial benefits for customers and for the environment.
23. The Cave review highlights the need to manage the risk associated with reform. In particular, it emphasises the importance of gathering better and deeper information on the workings of the vertically integrated companies at the upstream level.
24. In these turbulent economic times, the need to ensure that UK businesses maintain a competitive position is paramount. Their freedom to choose and manage the resources they employ is critical to this objective. Developing an effective retail market will produce important price and service benefits to commercial customers of all sizes.
25. The Cave review sets out a number of important reforms designed to build a framework within which such a market may thrive.
26. Preparing the sectors for the challenges ahead is a significant project with much work left to be done. However, many of the reforms outlined in the Cave review are both ready for implementation and are needed to respond to conditions already challenging the companies.
27. These reforms will need legislative change. For this, the Flood and Water Management Bill, currently in draft, represents a very important opportunity.

1. Abstraction and discharge

The Cave review recommends:

- legislation to enable the Environment Agency to collect and publish trade prices to provide greater information to traders about the potential value of licences;
- using reverse auctions and other new methods to reduce licensed abstraction in over-abstracted areas;
- setting scarcity licence charges which better reflect environmental costs; and
- taking steps to reveal the true value of water.

Market signals can help deliver a more efficient use of water resources.

28. We consider that reforming the abstraction regime to allow trading of abstraction rights would help to begin to reveal a value for water, leading to better use of this increasingly scarce resource.
29. This is because the full economic, environmental and social value of water, in different locations and at different times is neither well understood nor taken into account when developing water supplies. This is a fundamental obstacle to sourcing raw water efficiently, which will be critical in meeting the challenges of the future.
30. Not recognising a value for water, for example, means that the companies cannot know whether it is more efficient, and better for customers, for them to build a new reservoir or trade and transfer water from another area where there may be a surplus. Taking steps to help reveal the true value for water will support the maintenance and improvement of environmental standards by indicating the very real environmental costs of abstraction and potentially reducing the need to build new supply capacity.
31. In February 2009, we published a [joint report](#) with the Environment Agency. This document identified some key measures to make abstraction trading easier. These included:
- making better information and guidance available (including prices at which licences are traded and the conditions which will be placed on trades). This will give those who hold licences, and those who wish to buy them more information about the potential value of licences;

- using a range of tools (such as reverse auctions) to reduce over-abstraction to a more sustainable level without restricting trades; and
- structuring licence charges to better reflect environmental costs.

32. We are pleased that the Cave review has recognised the important work we are doing with the Environment Agency in this area. We are continuing to work with the Environment Agency on further analysis and to implement the recommendations of our joint report.

33. However, we consider that legislation may be needed to allow the Environment Agency to price abstraction licences above the recovery of administrative costs and to recycle this revenue to customers. Legislation may also be required for trade prices to be collected and published, and to make payments to licence-holders following reverse auctions.

2. Upstream market mechanisms

The Cave review recommends:

- unbundling the current combined supply licence to provide opportunities for entrants to specialise in particular activities;
- removing the costs principle;
- introducing an economic purchasing obligation to ensure water companies procure the most economic and efficient assets and activities;
- increasing transparency by taking steps to publish water and sewerage supply costs at different stages in the value chain; and
- potential need for functional and legal separation of water companies in the future.

Upstream water and sewerage supply activities could offer the largest potential gains.

34. Upstream water and sewerage supply activities comprise:

- water treatment, distribution and sewage collection;
- sewage treatment; and
- sludge treatment and disposal.

35. Together, these upstream activities amount to up to 90% of the value of the sectors. The vast majority of the investment that the companies will have made in the period up to 2010 will have been in these upstream areas.

36. The challenges facing the sectors mean that there will continue to be a need to invest heavily in renewing and adapting upstream assets. Even a small efficiency saving could lead to a significant gain. For example, a 1% efficiency gain over the past 20 years, over and above the gains made through regulation based on mimicking markets, would have provided about £800 million of benefit for consumers.

37. Therefore, we support the Cave review's proposed step-by-step approach to developing market mechanisms in upstream water and sewerage activities. The Cave review recognised the importance of the upstream elements of the value chain and identified issues in relation to its reform. We consider that the first step must be to reveal new information about these activities.

38. We support the Cave review's recommendation to reform the current combined supply licence for new entrants by creating new upstream licences for companies wishing, for example, to introduce water into a company's network, or to carry out sewage or sludge treatment and disposal.
39. This will enable new entrants to enter a market in a range of ways, where they are most able to offer benefits, and to trade with other licensees. Again, this will help to ensure that future investment is as efficient as possible.
40. The Cave review recommends that there should be appropriate arrangements to incentivise and challenge the companies to pursue the most economic and efficient purchasing of new assets and activities.
41. Challenging companies' proposals is an integral part of our price review process. We will need to consider what additional value the Cave review's proposal for an 'economic purchasing obligation' would provide. In future, however, given the challenges facing them, the sectors will need more flexible regulation, and markets that are open to alternative proposals and solutions to meeting demand.
42. We consider that the Cave review's recommendation for further transparency of costs would be beneficial. If we are to regulate more effectively, we must better understand the inner workings of the vertically integrated monopoly water companies. Visibility of transactions between different stages of the value chain is critically important. As a first step, we are developing accounting and price control separation of companies' activities.
43. As the Cave review recognised, we may also need to consider whether to go further in due course, such as requiring functional or legal separation of certain upstream activities.
44. Upstream activities involve substantial long-lived capital assets. Much of the cost of past investment has been sunk on the understanding that the companies would earn a return on it through the regulatory regime.
45. Reform that affected returns on this investment would raise questions about the impact on financing costs. We recognise the importance of questions about the impact of any reform on financing and commissioned Richard Nourse to [explore](#) these issues. He identified a number of areas that will require consideration as reform is implemented.

46. We will ensure that the overall impact of reforms on financing costs is proportionate to the expected benefits. This is in line with our duties to protect the interests of consumers and to allow efficient companies to finance their functions. A step-by-step approach to reform will enable knowledge and understanding of upstream markets, and their impact, to develop and inform future steps. We will consult with the sectors and their investors before we take any relevant decisions on implementation.
47. In order to achieve upstream reforms in line with the Cave review's recommendations, legislative change through the final Flood and Water Management Bill is necessary to bring about the changes to licences and to the costs principle.
48. The Cave review has identified some key building blocks for reform. We will continue to progress this work. In particular, we will continue to develop our views about how the 'first step' upstream market arrangements should work. This is to ensure that the companies continue to deliver benefits to consumers and the environment.

3. Retail services market

The Cave review recommends:

- reducing the eligibility threshold for competition, to include all non-household customers in a competitive retail market;
- removing the current costs principle and replacing it with alternative ex ante access pricing arrangements to be determined by Ofwat;
- mandating common market codes to reduce market entry costs;
- mandating the legal separation of companies' retail services;
- extending retail competition to include sewerage services;
- introducing negotiated settlements as part of the price review process; and
- setting default tariff and service levels to protect customers in the competitive retail market.

An effective retail services market is a key reform.

49. We welcome the Cave review's recognition of the range of monetary and non-monetary benefits that creating a retail services market can bring about. We support an effective water and sewerage retail services market for non-household customers. Such a market can deliver savings and service improvements to eligible customers and drive benefits further up the value chain.

50. The report recommends a staged approach to removing the existing eligibility threshold, with an initial reduction to 5 megalitres (Ml). We support this approach and agree that all 1.2 million non-household customers in England and Wales should subsequently be able to choose their supplier, with levels of service, products and tariffs that satisfy their individual needs.

51. We agree with the Cave review's recommendation to remove the current, highly inflexible, costs principle from legislation, and instead enable Ofwat to determine access pricing rules and access prices, ex ante. This will remove a major barrier to the development of markets. The limitations of the costs principle, fixed in primary legislation, have largely prevented entry, because entrants into the market have to compensate existing water companies for any loss resulting from a reduced market share.

52. We also agree that the mandatory legal separation of retail operations is necessary to create an effective retail market and help prevent anti-competitive behaviour. Separate accounting and price controls will act as an important first step towards implementing legal separation.
53. We will advise the Government on whether it would be appropriate to introduce a threshold below which it would not be mandatory for small companies to legally separate and, if so, the level at which this should be set. We will publish that advice in due course.
54. We also support the recommendation to use legislation to extend retail competition into both water and sewerage services.
55. The Cave review considers the case of one company, Dŵr Cymru (Welsh Water), which is wholly owned by Glas Cymru, and which is a company limited by guarantee. It is entirely debt financed. We agree that implementing the Cave review's retail separation and competition recommendations would not undermine the advantages of this arrangement. We consider that retail competition would in fact provide the opportunity to test the advantages of this model.
56. The Cave review makes a number of recommendations for further developing customer engagement with quality and service standards and incentives, based on 'negotiated settlements'.
57. We support fully the principle that the views of customers are a very important element in the regulatory process, including setting service standards. Indeed, our existing approach to price setting already places customers at the heart of the process, incorporating three stages of consumer research, working closely with other stakeholders.
58. Using negotiated settlements as part of the price setting process is an option we are considering as we contemplate our approach to regulation in light of the challenges facing the sectors. We will continue to explore carefully the best ways in which greater customer engagement can be achieved, learning the lessons from other sectors and countries.
59. We are already strengthening the incentives on companies to focus on meeting the needs of their customers. We are introducing new measures based on the consumer experience and placing them at the heart of our incentive mechanism. This is in line with the Cave review's thinking.

60. The Water Industry Commission for Scotland (WICS) has made effective use of default tariffs and service levels to protect non-household customers as the new retail market develops. Similar mechanisms for England and Wales may also be appropriate.

61. We will continue to watch the developing retail market in Scotland and will liaise closely with WICS and other regulators as we develop market design.

62. In order to achieve retail market reforms in line with the Cave review's recommendations, primary legislation is needed to:

- remove the costs principle and enable Ofwat to determine access prices ex ante;
- mandate the legal separation of companies' customer facing retail activities;
- extend the competitive retail services market to sewerage retail services, complementing the existing market for trade effluent services; and
- mandate common market and operational codes.

63. Secondary legislation is required to reduce the eligibility threshold for non-household customers. (Primary legislation would be necessary following any future decision to extend eligibility to household customers.)

64. We recognise the significant volume of work that is needed to make a well-functioning retail market a reality. The Cave review suggests that Ofwat carries out further work in consultation with the sectors and other stakeholders to develop the detail underpinning its recommendations.

65. Work with stakeholders to develop this detail is under way, including preparation to reduce the eligibility threshold to 5 Ml a year for non-households.

4. Industry structure

The Cave review recommends:

- Introducing a two-stage test for the special merger regime whereby the Office of Fair Trading could decide whether to refer mergers following advice from Ofwat on the impact on comparative regulation;
- increasing the turnover threshold for merger control under the special merger regime from £10 million to £70 million; and
- excluding retail-only businesses from the special merger regime.

Reforms to the structure of the sectors must ensure that customers are protected.

66. The Cave review recommends introducing a new first stage test for considering water mergers under the special merger regime. We support this proposal to reform the current system for company mergers. However, we cannot support the implementation of the Cave review's recommendations to raise the special merger regime turnover threshold, and to exclude monopoly household retailers from the regime, until it can be demonstrated that customers will be protected in some other way.
67. Currently, mergers are referred automatically to the Competition Commission in cases where the smaller company has an annual turnover in excess of £10 million. Under the Cave review proposal, for a new first-stage test, the Office of Fair Trading would decide whether to refer mergers, on advice from Ofwat. We support this recommendation, which would allow the application of the special merger regime to evolve as markets develop. It would also enable beneficial market restructuring while continuing to protect customers.
68. It is critical that we are able to continue to protect customers through effective regulation of those parts of the value chain which are not or not yet, subject to effective competition. We currently use comparative regulation to provide this protection to customers. This involves testing and challenging each company on the basis of real evidence drawn from the actual performance of rivals. This has proved to be a highly effective tool over the last 20 years, resulting in bills 30% lower than they would otherwise have been. For comparative regulation to work effectively, we need to maintain a sufficient number of independent companies to use as comparators.

69. The Cave review's recommendation to raise the turnover threshold for the special merger regime could have the effect of reducing significantly the number of comparators. We currently rely on comparative regulation to protect all customers, and until competition and choice are sufficient to replace such protection, this reform would seriously undermine our regulatory approach. In these circumstances, we would no longer be able to protect customers effectively if this recommendation were to be implemented.
70. The Cave review also recommends that retail only-mergers are excluded from the Special Merger Regime. Where competition is not able to provide adequate protection for customers, comparative regulation or some other form of regulatory protection is essential. This includes the effective regulation of retail services for household customers, who will still be unable to choose their supplier. Excluding retailers from the Special Merger Regime would similarly significantly reduce the number of effective comparators in this part of the value chain. This would also seriously undermine our existing regulatory approach and our ability to protect customers.
71. Therefore, we cannot support the implementation of the recommendations to raise the turnover threshold and exclude monopoly household retailers from the special merger regime, until it can be demonstrated that customers will be protected in some other way.
72. Legislation is required to introduce the new first stage to the special merger regime and to ensure that the special merger regime will cover retail licensees serving 'captive' household customers.

5. New appointments

The Cave review recommends:

- allowing new entrants to specialise in providing upstream, network or retail services;
- reforming the approval process for new appointees;
- giving the Drinking Water Inspectorate (DWI) a greater role in the approval process;
- introducing a binding market framework of regulated access for new appointments;
- clarifying and defining an ‘unserved’ site; and
- ensuring prices are cost reflective and apportioned fairly.

New appointments are an important way of enabling market entry.

75. The Cave review has usefully considered the current new appointments regime and made a number of recommendations, some of which are already part of our existing approach.

76. It is important to recognise that the new appointment regime is simply the process by which existing incumbent water companies change their appointed business areas, and entrants become new appointed water companies. Once appointed, new water and sewerage companies have the same rights, duties and obligations in law as the existing companies.

77. New appointments represent an important mechanism for enabling market entry. We support the Cave review’s recommendation to reduce entry barriers where this does not reduce the protection customers receive. We consider that introducing a binding framework of regulated access for new appointees, and common codes and systems for supply would help to reduce such barriers.

78. Currently, one way in which new appointees may enter the market is by applying to supply unserved sites. We think that clarifying the definition of ‘unserved’ would also help applicants and incumbents understand whether an application is valid. This would streamline the application process.

79. We agree with the Cave review's view that customers served by new appointments should be no worse off than if they were served by the local incumbent over the long term. This requires a robust approval process for new appointments. It should include having regard to the marginal effect on an applicant's business of further variations to its existing appointment and existing customer base. Similarly, it is important that water quality be protected, so we support the Cave review's recommendation to give the DWI a greater role in the process.
80. Prices and other charges must reflect costs, which must be apportioned fairly among the relevant parties. In so doing, it is important to consider the effects on existing and future customers of the way incumbents recover the costs of new connections and network expansion over time.
81. The Cave review also recommends allowing entrants to specialise in providing upstream, infrastructure or retail services subject to a supplier of last resort obligation. In taking this forward, we think it is vital that the right structure to protect customers is in place. This includes allocating the existing duties and responsibilities to each of the upstream treatment, infrastructure or retail service providers correctly.
82. Legislation is needed to bring about changes to the existing framework for new appointments to allow entrants to specialise. Whatever structure of licences and appointments is eventually put in place, it is important that entry from outside of the group of existing companies is still allowed.

6. Innovation

In line with its terms of reference, the review made recommendations on innovation for us to consider ahead of the next price review. These include:

- placing a new innovation duty on Ofwat;
- requiring Ofwat to report on progress every five years;
- setting up a new Research and Development body with funding for companies wishing to undertake research into innovative new approaches; and
- suggested changes to the balance of incentives on companies within the regulatory regime.

New measures are required to stimulate innovation in the water and sewerage sectors.

83. Effective innovation is vital if the sectors are to meet the future challenges they are facing. Overall, across the economy, competition is the best way to stimulate innovation. Where there is insufficient competition, economic regulation has put in place incentives to innovate. Since privatisation, the framework of incentive-based regulation has delivered substantial improvements in service and efficiency.

84. We place a high priority on incentivising innovation through regulation. This includes allowing companies to retain all of the profits from outperformance (much of this the result of innovation) for up to five years before the benefits are passed to customers. We also provide enhanced benefits for the leading companies to encourage further innovation.

85. Our approach to economic regulation continues to evolve in light of emerging evidence. A number of recent measures, which we have taken, aim to promote further innovation, including:

- setting water efficiency targets;
- integrating the consideration of carbon impacts into investment analysis; and
- improving the incentives for innovative capital investment planning – the capital expenditure incentive scheme for the 2009 price review.

86. The challenges of the future also provide opportunities to innovate. We have encouraged the companies to respond to these new opportunities by highlighting the key emerging issues. This can be seen in our approaches to climate change and sustainability.

87. For example, our [climate change policy statement](#), published in July 2008, sets out our direction of travel in integrating long-term climate change issues into the way we regulate. This provides the companies with the basis on which to develop their forward thinking and investment in developing innovative solutions.
88. Beyond these activities, market mechanisms have the potential to provide further incentives to stimulate innovation through much the water and sewerage value chain by introducing competitive pressures. We will continue to improve regulatory incentives and mechanisms where such competition is not possible. The Cave review's recommendations in relation to regulatory incentives will form a useful input into our review of regulation once the 2009 price review process is finished.
89. The Cave review has recommended that a new duty to promote innovation be placed on Ofwat. As an independent regulator, it is important that our statutory remit is comprised of limited, clearly defined duties and that the statutes should give a clear steer as to how those duties should be prioritised¹. It is not clear from the review what this duty would entail, or therefore, what value it would add over and above existing duties or for customers.
90. The review has also suggested setting up a new Research and Development fund for companies wishing to undertake research into innovative new approaches. We have reservations about the review's proposal that customers should part-fund additional R&D resources for companies. The review has also recognised the valuable work that we have begun through the Technology Strategy Board to explore the scope for an 'innovation platform' for the water and sewerage sectors. We welcome the development of better targeted support for research and development on solutions to key long-term challenges for the sectors.

¹ House of Lords Select Committee on Regulators, 1st Report of Session 2006–07, 2007, 'UK Economic Regulators';
<http://www.publications.parliament.uk/pa/ld200607/ldselect/ldrgltrs/189/189i.pdf>

7. Conclusion

	What Cave recommends	What we are doing	What we need
Abstraction and Discharge	<p>Legislation to enable the Environment Agency to collect and publish trade prices to provide greater information to traders about the potential value of licences.</p> <p>Using reverse auctions and other methods to reduced licensed abstraction in over-abstracted areas.</p> <p>Setting scarcity licence charges and conditions that better reflect environmental costs.</p> <p>Taking steps to reveal the true value of water.</p>	<p>We are continuing to work with Defra and the Environment Agency to implement the recommendations of our joint project on abstractions. The Cave review endorsed this approach.</p> <p>We will be working to streamline the existing trading processes and introduce market signals to ensure a more efficient use of existing water resources.</p>	<p>Legislation to allow the Environment Agency to make fees for abstraction licences exceed the recovery of administrative costs and to enable trade prices to be collected and published.</p> <p>Depending on the approach adopted, legislation may also be required to enable the Environment Agency to establish sustainable abstraction levels by means of reverse auctions.</p>
Upstream market mechanisms	<p>Unbundling the current combined supply licence to provide opportunities for entrants to specialise in particular activities.</p> <p>Removing the costs principle.</p> <p>Introducing an economic purchasing obligation to ensure water companies procure the most economic and efficient assets and activities.</p> <p>Increasing transparency by taking steps to publish water and sewerage supply costs at different stages in the value chain.</p> <p>The potential need for functional and legal separation of water companies in the future.</p>	<p>We will continue to explore future ‘first step’ opportunities for using market mechanisms in upstream activities. The starting point for this will be to open the companies’ upstream activities to greater transparency through accounting and price control separation.</p> <p>We will also consider whether there is a case for going further than this in requiring functional or legal separation of these upstream elements. The overall impact of any upstream reforms in the future must be cost beneficial, including any impacts on financing. We will consult with the sectors and their investors before implementing any reforms in this area.</p>	<p>In order to achieve upstream reforms in line with the Cave review’s recommendations, we consider that legislative change is necessary to bring about the changes to licences and to the costs principle.</p>

<p>Retail services market</p>	<p>Reducing the eligibility threshold for competition, to include all non-household customers in a competitive retail market.</p> <p>Removing the current costs principle and replacing it with alternative ex-ante access pricing arrangements to be determined by Ofwat.</p> <p>Mandating common market codes to reduce market entry costs.</p> <p>Mandating the legal separation of companies' retail services.</p> <p>Extending retail competition to include sewerage services.</p> <p>Introducing negotiated settlements as part of the price review process.</p> <p>Setting default tariff and service levels to protect customers.</p>	<p>We still have to establish much of the detail necessary to introduce an effective retail market for water and sewerage services.</p> <p>We will continue to work on developing this detail, in line with the review's recommendations. In due course we will develop and publish the necessary retail framework, including:</p> <ul style="list-style-type: none"> • common market and operational codes; • a new access pricing methodology; and • other details underpinning the retail model. <p>We have issued advice to the Government on whether it would be appropriate to set a threshold for smaller companies, below which these companies would not be required to legally separate their retail functions.</p>	<p>In order to achieve retail market reforms in line with the Cave review's recommendations, primary legislation is needed to:</p> <ul style="list-style-type: none"> • remove the costs principle and allow us to replace it with cost based access prices on an ex-ante basis; • mandate the legal separation of companies' customer facing retail activities; • extend the retail services market to sewerage; and • mandate common market and operational codes. <p>Secondary legislation is required to reduce the eligibility threshold.</p>
<p>Industry structure</p>	<p>Introducing a two-stage test for the special merger regime whereby the Office of Fair Trading could decide whether to refer mergers following advice from Ofwat on the impact on comparative regulation.</p> <p>Increasing the turnover threshold for merger control under the special merger regime from £10 million to £70 million.</p> <p>Excluding retail-only businesses from the special merger regime.</p>	<p>The special merger regime underpins our approach to protecting those household customers who cannot choose their supplier.</p> <p>A two stage test would be beneficial as it will allow the application of the special merger regime to evolve as markets develop. It will also enable beneficial market restructuring while continuing to protect customers. We will continue to work with the UK Government on the implementation of this reform.</p> <p>We cannot support the implementation of the recommendations to increase the special merger threshold and remove retail only</p>	<p>Legislation is required to introduce the new first stage to the special merger regime and to ensure that it will cover retail licensees serving 'captive' household customers.</p>

		mergers from this regime. We must first be certain that customers will be protected in some other way.	
New appointments	<p>Allowing new entrants to specialise in providing upstream, network or retail services.</p> <p>Reforming the approval process for new appointees.</p> <p>Giving the Drinking Water Inspectorate (DWI) a greater role in the approval process.</p> <p>Introducing a binding market framework of regulated access for new appointments.</p> <p>Clarifying and defining an unserved site.</p> <p>Ensuring prices are cost reflective and apportioned fairly.</p>	<p>We are currently reviewing our approach to the assessment of applications for new appointments and aim to make the application process clearer and smoother. We are also reviewing our policy in relation to bulk supply pricing. In addition, we will, as part of our review of regulation following the current price review, consider the way in which we regulate new appointees.</p>	<p>Legislation will be needed to bring about changes to the existing framework for new appointments to allow entrants to specialise.</p>
Innovation	<p>Placing a new innovation duty on Ofwat.</p> <p>Requiring Ofwat to report on progress every five years.</p> <p>Setting up a new research and development body with funding for companies wishing to carry out research into innovative new approaches.</p> <p>Suggested changes to the balance of incentives on companies within the regulatory regime.</p>	<p>We will continue to improve regulatory incentives and mechanisms where competition is not possible. The Cave review's recommendations in relation to regulatory incentives will form a useful input into our review of regulation once the 2009 price review process is finished.</p> <p>The review has recognised the valuable work that we have begun through the Technology Strategy Board. Research and development expenditure in the sectors has fallen substantially during the last 20 years and we support additional investment by water companies.</p>	<p>Ofwat places a high priority on incentivising innovation and we have introduced a number of recent reforms to further incentivise innovative practises. Introducing a specific duty on Ofwat to promote innovation would require an amendment to primary legislation.</p> <p>As an independent regulator, it is important that our statutory remit is comprised of limited, clearly defined duties. It is not clear from the review what this duty would entail, or therefore, what value it would add over</p>

			<p>and above existing duties or for customers.</p> <p>We will continue the valuable work that we have begun through the Technology Strategy Board to explore the scope for an innovation platform for the water and sewerage sectors. We welcome the development of better targeted support for research and development on solutions to key long-term challenges for the sectors.</p>
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Ofwat
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