

Ian Pearson MP
Minister for Climate Change and the Environment
Department for Environment, Food and Rural Affairs
Nobel House
17 Smith Square
London SW1P 3JR

28 November 2006

Dear Minister

At our meeting on 19 October 2006 we briefly discussed the development of market competition in the water sector in England and Wales.

The Water Act 2003 sets out the provisions that underpin the Water Supply Licensing regime (WSL), which came into effect on 1 December 2005. In its consultation and report leading up to the passing of the legislation, Defra set out clearly the positive policy objective of promoting the development of competition in the interests of water customers. For example the July 2002 consultation paper stated¹:

“The Government believes that the properly managed development of competition in the water industry in England and Wales is desirable as this should lead to greater efficiencies, keener prices, innovation and better services, to the benefit of customers. The Government also believes that competition must be balanced against its wider objectives to protect public health, protect and improve the environment, meet the Government’s social goals, and to safeguard services to customers.”

Almost one year on, we are concerned that there has been little or no progress in the development of competition. To date no customer has switched water supplier and it is our view that the WSL regime as it is currently constructed may not deliver on the promise to promote effective competition.

The WSL is constrained by two major factors. The first of these is the size of the contestable market, which is set at a threshold level that results in only approximately 2,300 customers being eligible to switch suppliers. The second factor is the very small margin that we are seeing as a result of the application of the mechanism for calculating the access price for new entrants to use the incumbent’s water network (the “costs principle”). With low volumes of customers and potentially very low margins, new entrants could argue that it is difficult for them to make a viable business case, even if they are efficient.

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¹ Paragraph 1, “Extending opportunities for competition in the water industry in England and Wales - Consultation document”, Department for Environment, Food and Rural Affairs and the Welsh Assembly Government, July 2002.

There are a number of other factors compounding these difficulties. For example the regime precludes Ofwat from setting or approving terms or conditions of access agreements **unless** a licensee specifically requests our intervention in relation to a specific case involving a specific customer. While Ofwat can and does issue guidance on such agreements, so far Ofwat has received no disputes in relation to access on which we can determine and so move the market on.

In addition, it is not clear to players in the market how the WSL regime and/or the older "inset appointment" mechanism can facilitate the effective competition that would deliver benefits to customers.

We believe that, on the first anniversary of the WSL, it is time to review why the regime is not working as well as many hoped it would and to decide on appropriate actions to move it forward. We do acknowledge that Defra did state at the outset of the regime that it would review the threshold in 2008, and that it initially took a cautious approach to the roll-out of competition, but we believe it is inappropriate to wait until then when the evidence suggests there will be little or no progress in the meantime. In fact, we are concerned that the uncertainty and the constraints in the regime will only add costs for all parties who are trying to make the regime work (new entrants, incumbents and Ofwat) while delivering little in the way of benefits to customers.

Ofwat has already initiated an internal review of those aspects of the WSL that are within our scope to address, together with the various other regulatory tools for facilitating competition such as self lay and inset appointments. We will be looking to identify any barriers or obstacles to competition and how those might be addressed. We believe it is appropriate at this stage that Defra also starts to review the key characteristics of the WSL that are set in primary and secondary legislation (the cost principle and the threshold for contestability), to see if it would be appropriate to change either or both of these. We would be happy to work with Defra on these issues and to share any information or work on our internal review .

We are available to discuss this further with you and your officials and will be happy to share with you the outcome of our own review of competition in the water sector in the new year.

I have also copied this letter to Carwyn Jones and we will be happy to share our work with the Welsh Assembly Government, as well.

Yours sincerely,



Regina Finn