

Outcomes of Ofwat's internal review of market competition in the water sector

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Executive summary

Ofwat is the economic regulator for the water and sewerage sectors in England and Wales. Water and sewerage services are, in most cases, provided by a series of vertically integrated regional and local monopolies. The regulatory regime is designed to act as a proxy for competition in the market for the supply of such services; to stimulate rivalry between firms; and provide benefits to customers that market competition would otherwise provide.

Since April 2005, Ofwat has had an explicit duty to exercise and perform its powers and duties in the manner in which it considers is best calculated, amongst other things, to further the “consumer objective”. Namely, this is to protect the interests of consumers, wherever appropriate by promoting competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services. Ofwat also has certain powers, exercisable concurrently with the Office of Fair Trading (OFT), to enforce the Competition Act 1998 (CA98) in the water and sewerage sectors. In addition, in December 2005 the Water Supply Licensing (WSL) regime (enacted by the Water Act 2003) came into force. The WSL regime is designed to open up a small part of the water supply market to competition (only about 2,200 consumers, out of 23.4 million, are currently eligible under the new regime). Ofwat is charged with implementing the WSL regime.

We believe that consumers’ interests will be protected if we promote effective competition wherever possible in the water and sewerage sectors. However, while our main duties apply to both services, the WSL framework applies only to water. In seeking to implement the WSL regime, it has become clear that the current regime is not, and is not likely to be, successful in delivering either effective competition or customer benefits. Consequently, Ofwat initiated an internal review of the state of competition to date, looking mainly at WSL. We wanted to analyse why there has been little WSL progress, despite the efforts of Ofwat, customers, licensees and water companies to make the regime work. We also wanted to identify any changes Ofwat could implement to make progress under the current regime. Furthermore, we wanted to consider what other options there might be to increase the prospects of competition.

Although the review has been internal, we have considered information gathered from a variety of sources during the implementation of the regime. We have also worked with key stakeholders, most notably members of our industry working groups. We have used this information to inform the direction and scope of our review.

Our internal review was the first step in evaluating the effectiveness of our various tools for competition. This paper sets out the findings of this review. It shows that Ofwat can make some changes now (albeit limited ones, and mostly subject to consultation) to refine our existing policy. For example, later in April we will issue a WSL letter to highlight best practice and we will consult on changes to our WSL guidance documents. Chapter 5 gives more detail about the actions we are proposing to take in April.

A key finding of our review is that the Costs Principle, the mandatory regime for setting access prices payable by a WSL licensee to an appointed water company, which is set out in primary legislation, is one of the biggest obstacles to the development of competition in water supply. We are concerned that the other changes we could make now will not deliver effective competition without that major obstacle being tackled. We have already told Government that this was likely to be a conclusion of our internal review.

The same conclusion may not hold true for combined supplies, where indicative access prices suggest that, in some locations, very large discounts may be available to entrants who provide new water resources to replace appointed water company's planned resources.

We have also indicated to Government that the current eligibility threshold of 50MI per annum, set out in secondary legislation, is likely to be a further significant barrier to the functioning of the WSL regime.

The findings of our internal review have also shown that more work and public debate is required in order to decide upon our future approach to promoting effective competition for the benefit of consumers. Longer-term options for change require the engagement of a range of stakeholders and some changes would clearly require amended or new legislation

In considering a different framework for the future of competition in the water and sewerage industry, as well looking for ways to incentivise companies to compete, we must have regard to our wider duties, which include duties to:

- Enable efficient water and sewerage companies to finance their functions.
- Contribute to the achievement of sustainable development.
- Have regard to the interests of various vulnerable groups, including customers on low incomes and customers in rural areas.
- Ensure that customers in similar circumstances pay similar charges, and that any differences in charges properly reflect relevant differences in circumstances.

Our next steps are as follows:

- First we will move quickly to improve those aspects of the current regime that are within our control. We will consult publicly in April on possible changes to the current WSL framework.
- Second, we will consider the possible benefits of changes in primary legislation; and
- Third, we will consider more radical options for our long-term approach to competition in the water industry. As explained further in chapter 6, we will consult on these issues in June and, if appropriate, have a further round of consultation in November.

1. Background

This chapter briefly explains the structure of the water industry in England and Wales and the legislation underpinning its operation. It gives an overview of how the WSL regime has operated until now and what triggered our internal review, as well as noting our future work programme. The last part of this chapter sets out how the rest of this paper is structured.

1.1 Water industry background

Water and sewerage services are delivered to customers in England and Wales by appointed water and sewerage companies. Those companies are, in effect vertically integrated regional and local monopoly service providers. This industry structure was embedded when the regional and local water boards were privatised in 1989 and has been in place ever since, although there have been a limited number of mergers and takeovers.

Significant parts of the industry are generally acknowledged to have the characteristics of a natural monopoly, most notably the water and sewerage transportation networks. Given the very high up-front cost of building a water or sewerage network, it is unlikely, given current technology, that it would be economically sensible to duplicate large parts of that network. It is likely that these aspects of the value chain will continue to need regulating in the long term to protect consumers' interests. However, there are other parts of the industry that could be opened to competitive entry or be subject to competitive pressures. Ofwat seeks, wherever appropriate, to promote such competition as a means of delivering the best in price, choice and quality of service to customers. To date under the WSL regime there has been very little entry for a variety of reasons which are discussed later in this paper.

In the absence of effective market competition, regulation by Ofwat is aimed at delivering to customers the benefits that competition would otherwise bring. Nevertheless, regulation is, by its nature, always likely to be a 'second best' alternative to competition, not least because of the asymmetry of the information held by the regulated entities compared with the regulator.

1.2 Legislative background

In 2003 new legislation (the Water Act 2003 (WA03)) was enacted, which, amongst other things, provided a new framework for the development of competition in the water sector.

The WIA91, as amended by the WA03, provides that Ofwat shall exercise and perform almost all its key powers and duties under the WIA91 in the manner which it considers is best calculated (amongst other things) to further the “consumer objective”, i.e. to promote the interests of consumers, wherever appropriate by promoting competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.

The WA03 also introduced the WSL regime, which came into effect in December 2005. The WSL regime is intended to open up a limited part of the water market to competition. The WSL regime provides for the granting of water supply licences to companies (known as “licensees”). Two types of licence are available:

- A **retail licence** – a water supply licence that authorises the licensee to purchase a wholesale supply of water from an appointed water company and to use the appointed water company’s supply system for the purpose of supplying water to the premises of the licensee’s customers.
- A **combined licence** – a water supply licence that, in addition to the retail authorisation, allows the licensee to introduce water into an appointed water company’s supply system in connection with the supply of water to the premises of the licensee’s customers.

The WSL regime provides for the making of agreements (known as “access agreements”) for the provision of wholesale supplies of water by appointed water companies to licensees and the introduction of water by licensees into appointed water company’s supply systems. In default of agreement, Ofwat has powers to determine the period for which, and the terms and conditions on which, an appointed water company is to perform any duty under the WSL. Further details of the WSL regime are available in Ofwat’s revised Access Codes Guidance, published in September 2006.

Although Ofwat has numerous powers and duties in relation to the implementation of the WSL regime, it is important to note that the legislation contains certain limits over which Ofwat has no control, namely:

- Charges payable by a licensee to a appointed water company under a WSL access agreement or determination must be fixed in accordance with the “Costs Principle”,

a prescribed and prescriptive mechanism for calculating the access price (see section 66E WIA91). In particular, the Costs Principle is a retail minus, average costs approach¹;

- Specific eligibility requirements must be satisfied in relation to each of the premises supplied by the licensee. In particular, there is a threshold requirement that, at the time when the licensee first enters into an undertaking with a customer to give a supply, the total quantity of water estimated to be supplied to the premises annually pursuant to the undertaking is not less than 50 million litres. The effect of those eligibility requirements is that only around 2,200 very large water consumers are eligible to receive supplies from licensees; and
- Amongst other things, the intention and effect of the WSL regime, in general, and the Costs Principle, in particular, is that those consumers who are not eligible to benefit from the WSL regime should not be disadvantaged by the operation of the regime.

The WA03 also formalised competition in laying new water pipes, known as “self-lay”.

1.3 Operation of the WSL to date

Since December 2003 stakeholders, including Ofwat, new entrants, customers and appointed water companies, have been working to design and implement the regime set out in legislation. In developing our guidance, Ofwat has taken on board the views of the industry (including new entrants). This has been true when updating the guidance in the light of experience. When developing policy we have also worked with advisory groups, which include customers, CCWater, appointed water companies and new entrants. Since the regime went ‘live’ in December 2005, we have also monitored it closely to assess progress and have from, time to time, updated the guidance in response to emerging issues. We continue to develop policy to improve the regime.

So far no customer has switched supplier under the WSL regime. Seven licences have been granted, two to new entrants and five to companies associated with existing water companies. Also, to date negotiations have focussed on agreements for wholesale supplies rather than for combined supplies.

1. Strictly speaking these are costs that can be Avoided or Reduced, or any amount that is Recoverable in some Other Way (ARROW).

1.4 Review of competition and WSL

In view of this lack of progress we decided to initiate a review of competition in the water sector in general and of WSL in particular. We have carried out initial work to summarise the current state of the competitive market (predominantly with regard to the WSL regime, inset appointments and self-lay) and to identify how Ofwat can improve prospects for effective competition in the short term.

However, it is also clear from our initial work that it is timely to take a wider look at competition in the water and waste water sectors generally and consider how effective competition might best be fostered, consistently with our regulatory duties, especially our primary duty to protect consumers' interests (one of our four primary duties).

In November 2006 we wrote to Ian Pearson MP, Minister for Climate Change and Environment, noting our concerns that WSL is constrained by the high threshold requirement and the Costs Principle. We suggested that Defra could review now whether it would be appropriate to change either or both of the Costs Principle and the threshold. The Minister welcomed our review in the light of the lack of customers switching under the WSL regime and stated that Defra will consider the merits of reviewing the threshold before 2008.

This paper describes the outcome of our initial review of WSL and also sets out a work programme for a wider review of competition in the sector, including consultations and other opportunities for stakeholders to engage in that review. These next steps, explained further in chapters 5 and 6, include:

- A WSL series letter, to be published later in April, to highlight best practice and ask appointed water companies to publish their draft wholesale master agreements (WMAs).
- Work with the Environment Agency to promote combined supply competition by raising awareness of available raw water resources.
- A consultation in April on proposed changes to WSL guidance, including improving the way the current regime works in the short term. We will then publish revised guidance.
- A parallel consultation on changes to appointed water companies' conditions of appointment that might further promote effective competition.
- A consultation in June on a broad range of possible options for the longer term. This recognises the need for more work and a wider public debate in order to decide upon our future approach to competition in the water industry. Many of these will be issues that have been debated in the context of competition in other industries, although we recognise that the water sector has some significant differences from

other industries. Chapter 6 gives more explanation about the kinds of issues to be considered. Any proposals coming out of the debate would require support from key partners to implement (e.g. Defra, Environment Agency), as well as Parliament, and other stakeholders.

A timetable for the work outlined above is shown in chapter 7.

At the same time as the work explained above we will, as noted in our forward programme, initiate work to clearly identify the cost and value of water at each stage of its journey, from source to tap and of waste from sink to sea. Understanding this for each stage of production, transportation and supply will help, amongst other things, in identifying where competitive pressures could be most effective. This will allow us to design regulatory interventions in a proportionate and targeted manner. Although this work is important to the review, it will not hold up the other strands of work we are currently undertaking to improve the functioning of the WSL regime in the short term.

1.5 Structure of the paper

The rest of this paper is structured as follows.

- Chapter 2 sets out the views of stakeholders, including representatives on Ofwat's industry advisory groups.
- Chapter 3 summarises the current state of WSL, inset appointments and self-lay in order to identify the main areas that require action and to inform future work.
- Chapter 4 provides a comparison between the WSL regime and the new competitive regime in Scotland.
- Chapter 5 sets out the changes that we propose to make to our approach to WSL within the current framework, some of which we will implement now and others on which we will consult in April.
- Chapter 6 provides an initial list of options for wider changes to the industry, on which we intend to consult in June.
- Chapter 7 sets out the proposed next steps of our review of competition.
- Appendix 1 provides an overview of the current legal framework and the various powers available to Ofwat.
- Appendix 2 contains a glossary of terms used in this document.

2. Stakeholders' views

This chapter sets out the views of stakeholders.

2.1 Advisory Groups' views

As part of our internal review, we asked stakeholders represented on our industry advisory groups (appointed water companies, licensees, customers and CCWater) to provide initial feedback on the current competition regime (not just on WSL) and to suggest ways in which it could be improved.

Stakeholders consider that the current WSL regime is not working. Along with licensees, appointed water companies and CCWater, we consider that there have been unnecessary delays, which have slowed negotiations over WMAs and customer-specific applications. We have attempted to remedy these delays, where possible, since the WSL regime came into operation. It appears to us that delays, particularly in the early months of the WSL regime, were mostly attributable to appointed water companies. More recently licensees have contributed to the delays, for example by taking time to agree WMAs.

The main areas in which stakeholders suggest improvement to the WSL regime are:

- Customers are frustrated by delays in signing WMAs and want a quicker process.
- A lower threshold may stimulate competition but higher margins are needed too.
- Ofwat's interpretation of the Costs Principle should be reconsidered (although it is not necessarily wrong).
- Licensees want to broaden the customer base, possibly by redefining the term "eligible premises".

2.2 Competition Appeal Tribunal

One reason for recent delays was the uncertainty that stakeholders felt were created by the Shotton² case. However, following advice given at our advisory groups Ofwat issued a WSL letter on 20 February 2007 (WSL 01/07) to clarify its current position. In

2. Albion Water Limited v Water Services Regulation Authority (formerly the Director General of Water Services) (Dwr Cymru/Shotton Paper) 1046/2/4/04.

addition, Ofwat published the minutes of its Board meeting on 19 January 2007 where it considered whether or not to appeal the latest two substantive judgments of the Competition Appeal Tribunal (CAT). The CAT has to date given three substantive judgments in the main case; an interim judgment dated 22 December 2005, a main judgment dated 6 October 2006 and a supplementary judgment dated 18 December 2006. (On 2 February 2007 the CAT also published a judgement concerning Dwr Cymru's request to it for permission to appeal the main and supplementary judgements to the Court of Appeal.) The case concerns a proposed common carriage arrangement (for transport of water to a paper mill in Shotton in North Wales) that pre-dates the WSL regime. The appeal was brought under section 46 CA98 against a decision of Ofwat. Neither the decision nor the appeal focused on the Costs Principle or Ofwat's access codes guidance. The decision was taken in May 2004; the WSL regime (and the Costs Principle) only came into force on 1 December 2005 and was not therefore in force at the time of the decision. The access codes guidance was issued in November 2005, shortly before the WSL regime came into force. Although the CAT commented on the Costs Principle, those comments were obiter, which put simply is that they were comments on an issue not directly before the CAT in this case. The CAT criticised the result produced by Ofwat's interpretation of the Costs Principle but it did not identify any specific error or flaw in the access codes guidance. The CAT made it clear that such matters were outside the scope of its jurisdiction.

2.3 Business customers' views

In November 2006 CCWater and Ofwat commissioned research into the views of business customers on competition in the water industry. The research was conducted during February and March 2007. The research is based on a total sample size of 684 customers, of whom 501 are potentially eligible (i.e. use at least 50Ml of water per annum). The points set out below represent initial findings at this stage. The full report will be published on 27 April and will contain a more comprehensive set of results.

- A majority of respondents are aware of the WSL regime. The majority of eligible respondents indicated that they had heard about competition in water supply.
- Around two thirds of eligible customers and of ineligible customers (if they became eligible) are likely to consider switching.
- Two thirds of respondents would only switch once the regime had been successfully established.

3. Paragraph 356 of its third Judgment.

- Less than half of respondents are confident that the current regime will deliver benefits to customers.
- Very few respondents believe that WSL compares favourably with the market for supplies by other utilities.
- A majority of respondents would change supplier if prices reduced by 5%-10%.
- Less than half of respondents believe there are practical problems or barriers to the regime.
- There is strong support for a reduction of the threshold, allowing one supplier for multiple sites and the need for bigger margins.
- There is also support for the introduction of a national water supply network.

Stakeholders' views helped to inform our view of how the WSL market is operating, which is explained in chapter 3.

As we received limited feedback on inset appointments, we will seek further views on these in the June consultation. So far, stakeholders generally consider that the legal framework for inset appointments should remain unchanged. Potential inset appointees consider that a quicker application process with less regulation once an appointment has been granted would make them more attractive. Potential appointees would also like to see updated inset guidance with clear timeframes for processing applications. Stakeholders would also like to see the guidance aimed more at the emerging multi-utility market and for account to be taken of the interaction between the WSL regime and insets. Our views on inset appointments are set out in section 3.2 of chapter 3.

3. The current market for competition

This chapter provides an assessment of the current status of competition in the water sector, concentrating on WSL, inset appointments and self-lay.

3.1 WSL

We have revisited the Government's objectives for competition in water, following on from its 2002 consultation, 'Extending Opportunities for Competition in the Water Industry in England and Wales'. In that consultation, Defra said competition could expect to deliver:

- choice;
- keener prices;
- better services;
- innovation; and
- efficiencies.

This consultation led to the implementation of the WSL regime.

So far the competitive regime under WSL has failed to deliver these benefits. Since 1 December 2005 there has been little progress in WSL competition. No customers have yet switched supplier, few WMAs have been signed between licensees and appointed water companies, most WMA negotiations are taking too long to complete, and not even half of licensees appear to be actively engaging in WSL negotiations. However, there is some anecdotal evidence that some customers are experiencing better services from their appointed water companies than previously, as a consequence of the possibility of those customers choosing to be supplied by new entrants.

We have worked with members of our advisory groups and stakeholders more generally to understand the reasons for this slow progress. The main factors that stakeholders identified are the threshold, the access pricing regime and delays caused by a range of issues. This echoes the findings of all stakeholders as set out in chapter 2. They consider that the reasons for delay include:

- The fact the regime is new and as yet untested;
- Protracted negotiations by both licensees and appointed water companies over the content of WMAs;

- Protracted negotiations by both licensees and appointed water companies over some specific contract terms, particularly payment guarantees;
- Lack of clarity in our guidance;
- The level of application fees payable to appointed water companies by licensees; and
- Our lack of powers to formally determine terms of the WMAs⁴.

The volume threshold for the existing regime is limited by secondary legislation and the access pricing mechanism is set in primary legislation. However, Ofwat has been able to take steps on some aspects of the regime, including:

- Reducing the application fees that appointed water companies charge licensees for access to their water supply networks. Companies had fees ranging from £200 - £3,500 but we reduced these to a uniform maximum of £250 for retail applications. Companies had fees ranging from £5,000 - £10,000 but these were reduced to a maximum of £2,500 for combined supply applications.
- Facilitating trilateral meetings with appointed water companies and licensees to speed up progress on WMAs.
- Clarifying our guidance on issues such as security deposits and disconnections, to facilitate WMA negotiations.

Sections 5.1.1 to 5.2.3 of chapter 5 explain some further changes we propose to the WSL regime, within the current framework.

As part of our internal review we carried out a high level modelling exercise to supplement the feedback we have received directly from stakeholders. In particular this modelling helped us to better quantify the feasibility of new entry by licensees providing wholesale supplies under the Costs Principle. Details of the modelling are set out in section 5.2.1. Although this modelling was not company-specific, the modelling assumptions drew upon some company-specific information provided to Ofwat in support of the indicative pricing exercise in 2005.

As part of this exercise we examined the effects of two scenarios:

- The first one had conditions that were potentially favourable to entry – low set up costs for licensee, little inter-licensee competition, low appointed water company costs for serving the licensee, and appointed water company ARROW costs are correctly reported;

4. Under section 66D WIA91 Ofwat can in a case referred to it by a licensee, determine the period for which and the terms and conditions on which an appointed water company is to perform any duty under section 66A to 66C WIA91 (i.e. to give access), but only in relation to a customer/premises specific application for access.

- the second one had much less favourable conditions to entry – high set up cost for licensee, high inter-licensee competition, high undertaker costs for serving the licensee and undertaker's ARROW costs are under-reported.

The output from our modelling exercise confirmed our view that the Costs Principle is a significant constraint on the market. This is because:

- the WSL regime, as constructed, creates a new link in the vertical chain of supply that currently does not exist and this may introduce additional costs. The Costs Principle requires the licensee to pay these new transaction costs; and
- the licensee has to also pay the incumbent's unavoidable retail costs (e.g. sunk billing system costs) as well as its own retail costs (e.g. billing system costs).

While some customers may switch, overall, the results of the internal review indicate that retail competition is highly unlikely to flourish under the Costs Principle.

The same conclusion may not hold true for combined supplies, where indicative access prices suggest that, in some locations, very large discounts may be available to entrants who provide new water resources to replace appointed water company's planned resources.

3.2 Inset appointments

There are three circumstances in which an inset appointment can be granted:

- For an area in which each of the premises of one or more customers is supplied (or is likely to be supplied) with not less than 50 megalitres (MI) of water in England (250MI of water in Wales) in any period of 12 months. The same criterion applies in relation to inset appointments for sewerage services. We refer to this as the large user criterion.
- For an area which is not served by an incumbent appointed company – an unserved site. This includes an area that may be currently supplied by unregulated or private supplies with its own source of water. This criterion has to be met for water supplies for a water inset appointment application and for sewerage services for a sewerage inset appointment application.
- For an area where the incumbent appointed company consents to transfer that area to the inset appointee.

Inset appointments are where one company replaces another as the statutory water and/or sewerage company for a specified area of England or Wales. Essentially they replace one monopoly supplier with another. So while there is competition between

potential appointees up to the point the inset is made, after that time there is no ongoing competition in supply. Inset appointees would therefore continue to be subject to the comparative competition regime and hence treated the same as other water companies. In that sense, inset appointments are competition **for** the market, rather than competition **in** the market.

Of the eleven inset appointments which have been granted since 1997, four are large user, one is by incumbent consent and six are for unserved or 'greenfield' sites. All of these were in respect of business customers.

For some years there were few applications for inset appointments, but more recently several potential new entrants who want to supply new developments (through the unserved route) are pursuing an inset appointment. All of these proposals involve supplying household customers, and some include small non-household users too.

Where potential appointees seek to serve households, it is the developer and the potential appointee who take forward the inset proposal. End consumers have no influence in who becomes their monopoly water supplier. These consumers are entitled to the same protection as any other captive customer of a water company and so we consider it is right to use strong regulation to protect them. This is not the case for a large user inset; the customer has to give its consent to the appointment being made. In addition the customer has the ability to choose an alternative supplier. Consequently we believe there may be some scope for less ongoing regulation of the appointee where only large users are involved.

We will scrutinise proposals carefully for inset appointments, particularly when household customers are involved. We look at the viability of the proposal over time and what factors may affect it. The potential appointee must be able to show us, using sensitivity analysis around its preferred central case, that it will be able to withstand economic shocks. It also must be able to demonstrate that it has sufficient managerial and technical ability to operate as an appointee.

Once the appointment is granted, we will look to regulate inset appointees who serve households in the same way as we regulate existing appointees, although in a manner that is commensurate with the size and scope of the business. For example, we would look over time to set price limits and approve charges for an inset appointee, but would be unlikely to do this from the start of the appointment. Instead, we would suspend some of the conditions of appointment (such as Condition B) but include suitable 'triggers' (for example related to the size of the business and the time of the next periodic review of price limits) to bring the Conditions into effect later. In the absence of a price limit, however, we would at least want consumers to be no worse off than they would otherwise be. Therefore, we would normally expect the potential appointee to

cap the charges to its consumers at the level of the previous appointed water company's relevant tariff, in the first instance, until such time as a price limit was set.

Following RD12/06, 'Updating the inset appointment guidance' (August 2006) stakeholders welcomed our proposal to review our guidance for inset appointment applicants. As well as suggesting ways we might revise our guidance, they identified potential barriers with our current approach to the assessment of inset proposals. For example, some argue that the hurdles for new applicants are too high, that the application process takes too long and that price regulation of small companies is unduly burdensome.

We will look to streamline our process where appropriate, but we believe it is essential to continue taking a rigorous approach to assessing inset proposals that involve supplies to household customers, as those customers have no choice of supplier. Section 5.6 of chapter 5 summarises the changes we might make to the inset process.

3.3 Self-lay

Self-lay forms part of a market for laying water pipes for connection to the public water supply network. Developers can choose between employing a contractor to self-lay water pipes or requisitioning them from the appointed water company. The WA03 formalised self-lay with effect from 28 May 2004 by requiring appointed water companies to adopt self-laid mains and pay for those assets.

In autumn 2006, we surveyed the industry to ascertain the current state of the market for laying new water pipes. About 25% of the total connections so far in 2006-07 were self-laid, 95% of which were multi-lay, which developers consider to be the real driver of competition in laying new water pipes. Developers and contractors benefit from digging one trench for all services and the shorter time this takes compared with installing single services, as well as from dealing with one contractor for all services.

Although the mechanisms in WA03 appear to have had little effect in isolation, the uptake of self-lay has increased since 2004. In addition to the new legislation, the increase is attributable to:

- appointed water companies' revised self-lay policies;
- alignment with our levels of service;
- increased promotion to developers and Lloyd's Register's Water Industry Registration Scheme (WIRS).

Self-lay organisations benefit from one registration for the whole industry rather than having to be registered by each appointed water company and the scheme benefits the market by giving developers more confidence in contractors.

Although competition in laying new water pipes has increased, there is evidence of a geographical divide in the uptake of self-lay with more activity north of the midlands, moderate activity in Wales and less in the south of England. The survey shows that this is due to a number of factors: a lack of awareness amongst developers; other utilities' behaviour; water company attitudes; and fewer contractors operating in the south. Contractors appear to have promoted the competitive opportunity less to developers in the south of England than in the north. Stakeholders have suggested that this is because developers want to focus on multi-lay, but problems arise with this in the south because of alleged delays by electricity companies in providing information and connection terms. In addition water companies in that region have less experience of the self-lay process.

Another difficulty identified by the survey is delays by appointed water companies in connecting self-laid mains. Section 5.3.2 of chapter 5 sets out how we are considering dealing with this and the other issues mentioned above.

4. A comparison with Scotland

This chapter sets out the main features of the Scottish competition regime and compares them with the current WSL regime. The Water Industry Commissioner in Scotland (WICS) is in the process of opening the Scottish water market to competition. We have considered the model that WICS is using to see whether we can use any of the relevant policies to improve the WSL regime.

While undertakings in both regimes are subject to the CA98, each country has its own specific competition regimes in law. The following table explains the differences between the two regimes:

Key differences between the competition regimes in England & Wales and Scotland	
Legal differences	
Scotland	England & Wales
The Water Services etc. (Scotland) Act 2005.	Water Industry Act 1991 as amended by amongst other things the Water Act 2003.
Competition water and sewerage services.	Competition for water services only.
Competition restricted to retail services. Common carriage has been specifically ruled out.	Retail and common carriage is permitted.
Scottish Water is the sole appointed water company in Scotland and is required by the Scottish Act to set up a separate undertaking, to deliver retail elements of water and sewerage provision to non-household customers.	22 appointed water companies that will continue as vertically integrated, regional monopoly companies. We have no express powers to require ownership separation under the WIA91.

<p>Under the Act Scottish Ministers can give guidance on the charging principles to be followed and the objectives to be achieved by the water industry. As common carriage is ruled out in Scotland, there is no access charge and hence no requirement for a methodology to determine access charges. A wholesale charges scheme is required but this is not referred to in legislation.</p>	<p>Prescribed Costs Principle in the WIA91. Ministers have no specific powers to give guidance, but the July 2002 Defra consultation set out view on the broad objectives to be achieved from competition in the industry.</p>
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<p>Retail competition will apply to all non-household customers regardless of their sector, location or size. There is no threshold restriction determining those who can change supplier. There are approximately 130,000 non-household customers eligible to be supplied by licensed entrants.</p>	<p>Eligible customer must consume not less than 50 Ml/yr, at relevant premises, meaning there are approximately 2,200 eligible customers.</p>
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Policy differences	
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<p>A template wholesale service agreement (WSA) as a legally enforceable contract between the wholesaler Scottish Water and the licensed retailer. The WSA covers the water and sewerage services that Scottish Water agrees to provide to licensed retailers, and the commercial terms on which those services are provided. Scottish Water and licensees may depart from the template in appropriate cases, subject to Commission approval.</p>	<p>Wholesale master agreements negotiated on an individual basis, using Ofwat's access codes guidance. Licensees and appointed water companies have encountered problems reaching agreement.</p>
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<p>Wholesale prices for water and sewerage services will be determined in accordance with Scottish Water's Charges Scheme. Scottish Water has published indicative wholesale tariffs setting the charging structure. Customers' charges are not customer specific, but are banded based on meter size and consumption. Licensed providers are liable for the same charge if they have a customer receiving the same services.</p>	<p>Appointed water companies have published indicative access prices. Prices are customer-specific. They provide an indication of the prices that licensees will be charged if they are successful in applying for access to a water company's supply system; the actual price is likely to differ, depending on individual circumstances and subsequent negotiations.</p>
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Outcomes of Ofwat's internal review of market competition in the water sector

<p>Licensees and Scottish Water share payment guarantee by licensees paying charges in advance. The advance payment fluctuates between 6 and 2 weeks. The licensed provider (LP) only ever receives an invoice for a 4 week period (the invoice period). 14 days before the start of month 1, the LP will pay the charges for month 1. In month 1, 14 days before the start of month 2, the LP will pay the charges for month 2. This is the point where the LP has effectively paid for 6 weeks: there are 2 weeks remaining in month 1 that were paid for 14 days before the month started and there are 4 weeks in month 2 just paid for in month 1.</p>	<p>Appointed water companies currently request payment guarantees either as security deposits or up front payments.</p>
<p>Competition can be said to be based more on a 'regulated' regime than a 'negotiated' regime. There is a set of rules (embodied in the market codes) that apply equally to all retailers and regulate dealings with the wholesaler and competition between retailers. WICS' had substantial input into preparing legal documents, such as the template WSA, market code and operational code.</p>	<p>Our access codes guidance currently allows appointed water companies and licensees freedom to negotiate access agreements to suit their circumstances.</p>
<p>Scottish Water has no retailer of last resort duties but it must maintain physical supplies for two months. Licensees have an obligation to supply customers who approach them and offer default tariffs.</p>	<p>Appointed water companies have an interim supply duty to maintain supplies in the event of a licensee going out of business. And a duty to provide supplies for domestic purposes. Licensees can choose whom to supply.</p>
<p>Licensees have 'provider of last resort' duties where the Central Market Authority (CMA) will allocate them with customer supply points if another licensee goes out of business.</p>	<p>See above.</p>

<p>Non-households in Scotland can be disconnected for non-payment in accordance with WICS' disconnections code.</p>	<p>Appointed water companies are not able to physically disconnect a licensee's customer, but can agree with the licensee to terminate the supply agreement.</p>
<p>The Scottish Act requires Scottish Water to divest itself of its retail function for non-household customers. If Scottish Water were to retain a retail function for non-household customers it would be breaching the term of the Act. The effect of the Act is therefore to prevent Scottish Water from taking back customers.</p>	<p>Customers can switch back to appointed water companies.</p>
<p>Customer transfers operated by the separate CMA, including the registration of "customer supply points" as they switch from one licensee to another; the calculation of usage and wholesale charges; and the provision of that charging information to enable settlement of wholesale charges.</p>	<p>Customer transfers operated by each undertaker and licensee, using the customer transfer protocol (CTP). The CTP provides a transparent and standardised transfer forum to enable customers to switch. A separate company to organise transfers in a small market of around 2,200 customers is unlikely to be cost-effective.</p>

Many of the features of the Scottish regime highlighted above would require changes to legislation to introduce them in England and Wales and hence are not available to us under the current legal framework. We believe a reduction in the threshold for eligibility would be useful and this would require only a change in secondary legislation. This option is discussed further in chapter 6. Chapter 5 discusses various changes to our guidance that we will consult on, such as more prescriptive guidance and standard contract clauses. These changes would tend to move the WSL regime closer to the 'regulated access' approach taken by the WICS.

Stakeholders have contrasted the average 10% margin that is available to new entrants in Scotland with the lower indicative average retail margins in England and Wales (around 1% for 50MI customers, around 0.2% for 500MI customers). We will undertake more work to compare and contrast the two pricing regimes in the June consultation paper, but for now we note some important points about the average margin available.

In Scotland all of the costs of retailing to non-households are initially borne by Scottish Water Business Stream, who, in the absence of other entrants, will supply all the

customers. Therefore, the margin is based on all of the estimated costs of Scottish Water Business Stream. In contrast, the average indicative margins in England and Wales were calculated on the basis of a single eligible customer switching. As we said in our WSL 08/06 letter on indicative access prices in July 2006, we are likely to require undertakers to recalculate indicative prices later in 2007. As part of that process we may change the assumptions on which those calculations are made, for example to include an assumption that more customers switch.

In addition, while the average margin in Scotland is based on all of the costs of retailing, under the Costs Principle in England and Wales wholesale margins only take account of the undertaker's avoidable (ARROW) costs⁵, which are not likely to represent the full cost of retailing. This is exacerbated by the fact that any additional costs incurred by the undertaker in serving the licensee are deducted from ARROW costs, further reducing the margin available to entrants.

Another factor, which may contribute to the difference in average margins, is that in Scotland the entire non-household sector is eligible for competition, whereas in England and Wales eligibility is currently limited to customers consuming at least 50MI. Therefore, the average customer size in Scotland is <5MI which is much lower than the average customer size in England and Wales (around 250MI/yr). This average size may itself influence the average percentage margin available to entrants. For example, the costs of retailing are likely to form a larger proportion of a small customer's bill than a large customer's bill, because not all of the costs are volume related. Consequently, the fact that small non-household customers are eligible to switch in Scotland will tend to lead to a higher average percentage margin for entrants than in England and Wales⁶. In other words, if the average margin for all customers was broken down to different customer classes, the margin for larger than average customers in Scotland would be less than 10%.

5. Strictly, those costs that can be reduced or avoided, or are recoverable in some other way (other than from other customers of the undertaker) – see section 66E WIA91.

6. This is supported by indicative access prices in England and Wales, which for most water companies show a higher percentage discount for a 50MI customer than for a 500MI customer.

5. Proposals for change within the current framework

This chapter sets out changes that are within our power to make under the current framework. Ofwat is seeking to identify actions that can be taken to improve the prospects for the development of effective competition. Where we believe our guidance could be changed, we will consult first. In order to promote other changes more quickly, we will offer to the industry further suggestions on policy and encourage best practice via WSL letters, in discussions at our advisory groups and in discussion with other agencies (such as the Environment Agency).

5.1 Immediate actions

Wholesale supplies

- Issue a WSL letter highlighting current best practice and encouraging appointed water companies and licensees to adopt it;
- Ask appointed water companies to publish draft WMAs.

Combined supplies

- Work with the Environment Agency to raise awareness of available raw water resources.

As stated in section 1.2 of the access codes guidance all appointed water companies are required under section 66D WIA91 to produce an access agreement. But experience to date has shown that, at least in the early days, appointed water companies took some time to provide these documents. And furthermore, it is clear that there can be a considerable gap between the positions of the parties in negotiations. This has contributed to protracted negotiations about WMAs.

Of the negotiations we are aware of, licensees and appointed water companies have agreed most of the clauses in the draft WMAs. However, many negotiations appear to be stalling because these parties are unable to agree on a number of particularly contentious clauses, including:

- duration of the agreement;
- security deposits (and other payment guarantees);

- disputes about signed WMAs; and
- termination of the agreement.

We have strengthened our guidance on each of these areas, but few WMAs have been signed. We could overcome this by formally determining disputes about customer-specific applications for access, but as yet no licensee has referred a dispute to us. We asked our Operations Advisory Group (OAG) to look at the specific clauses and provide advice on what might constitute a best practice form of words.

On the duration of the agreement, the OAG has developed a best practice principle, which sets out that the WMA shall be an enduring document and subject to an automatic review after five years, or when both parties agree that relevant change has occurred since the WMA has been signed or when one party successfully appeals to Ofwat for a review. Examples of relevant change include changes to legislation (for example further changes to WIA91), regulations and industry governance. We will issue this to the industry in April as an appendix to the access codes template.

However, the OAG has been unable to agree principles for clauses on payment security, termination and disputes about signed WMAs. Ofwat will therefore take a view on these issues and set this out in our consultation on changes to our access codes guidance, as explained in section 5.2 of chapter 5 below. We will discuss proposed changes to our guidance with our advisory groups as we develop our consultation, so that their experiences continue to help inform our policy.

We will issue a WSL letter in April to highlight best practice arising from our trilateral meetings with appointed water companies and licensees, and from our responses to enquiries. To help smooth WMA negotiations we will ask appointed water companies, in the same WSL letter, to publish their draft WMAs. This will help licensees to compare how different appointed water companies approach issues, and enter negotiations with each appointed water company on a more informed basis. As stated above we propose to consider issuing a standard WMA, although we recognise that this may take time to agree because not all stakeholders supported the proposal when responding to previous consultations.

We are also taking steps to increase the awareness of opportunities to make combined and secondary supplies by strengthening our WSL guidance in these respects (see section 5.2.2 below) and we are working with the Environment Agency to raise awareness of the availability of raw water resources, to act as a stimulus to discover more opportunities for competition.

5.2 Proposals for changes to our WSL guidance (consultation in late April)

Following our internal review we have concluded that there are certain areas, albeit relatively limited, where we believe it could be useful to amend our WSL guidance without the need for changes in legislation. These are discussed further below.

5.2.1 Access codes guidance – price

Proposed changes:

Wholesale supplies

- To require appointed water companies to provide more detailed reporting about the retail services that they currently provide to customers and those they expect to provide to licensees.

Combined supplies

- To require appointed water companies to provide more detailed forecasts of the costs of providing different levels of additional resources.

Section 66D(3) WIA91 provides that the charges payable by a licensee to an appointed water company under a WSL access agreement/determination shall be fixed in accordance with the Costs Principle, set out in section 66E WIA91. The Costs Principle is therefore prescribed by statute as the basis on which access prices under the WSL regime must be calculated. Ofwat’s position is that the Costs Principle and the structure of section 66E WIA91 mandates – in essence – a “retail-minus” approach to pricing. That position was accepted by the CAT in the Shotton case (see chapter 2 above). Ofwat itself has no power to change that “retail-minus” approach to the Costs Principle, nor does it seem possible to interpret section 66E WIA91 in any other way. Any change would have to be made by primary legislation.

There are exemptions under the CA98 for appointed water companies complying with legal requirements. For example as set out above, appointed water companies must fix charges in an access agreement made in accordance with the Costs Principle. It follows that they do so “in order to comply with a legal requirement”, and to that extent the Chapter I and Chapter II prohibitions under the CA98 do not apply (see CA98, Schedule 3, paragraph 5).

It has, however, been suggested that Ofwat should reconsider its current approach to the starting point for the “retail-minus” calculation. In simple terms, we consider the

correct starting point to be what the customer currently pays the undertaker (usually the retail price). It has been suggested that we should consider changing the starting point to reflect the local cost to serve that particular customer or a certain type of customer.

The current retail tariff is a regionally averaged price. If tariffs were changed to reflect local costs rather than regional costs, the Costs Principle would then use that new tariff as the starting point in the retail-minus calculation. However, the (absolute) margin available to new entrants would continue to be determined by the “minus” component of the costs principle (i.e. ARROW costs), and hence such a change would not in itself facilitate competition.

Charts 1 and 2 show the current retail tariffs compared with tariffs in zones A and B based on local costs. The charts show that the margin available to new entrants is determined by ARROW costs, and thus is unaffected by changes in the structure of retail tariffs.

Chart 1 Margin for new entrants with uniform retail price

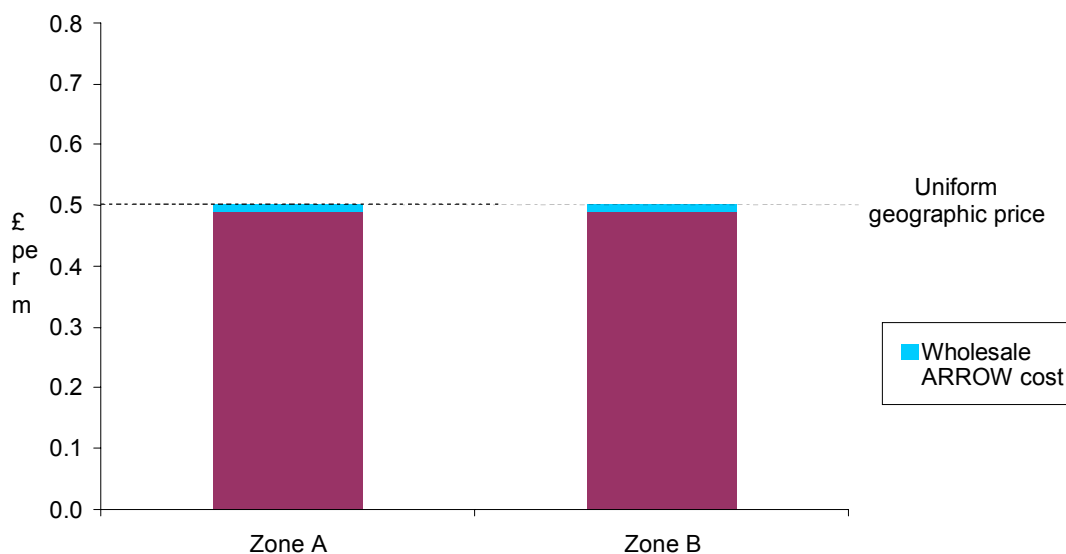
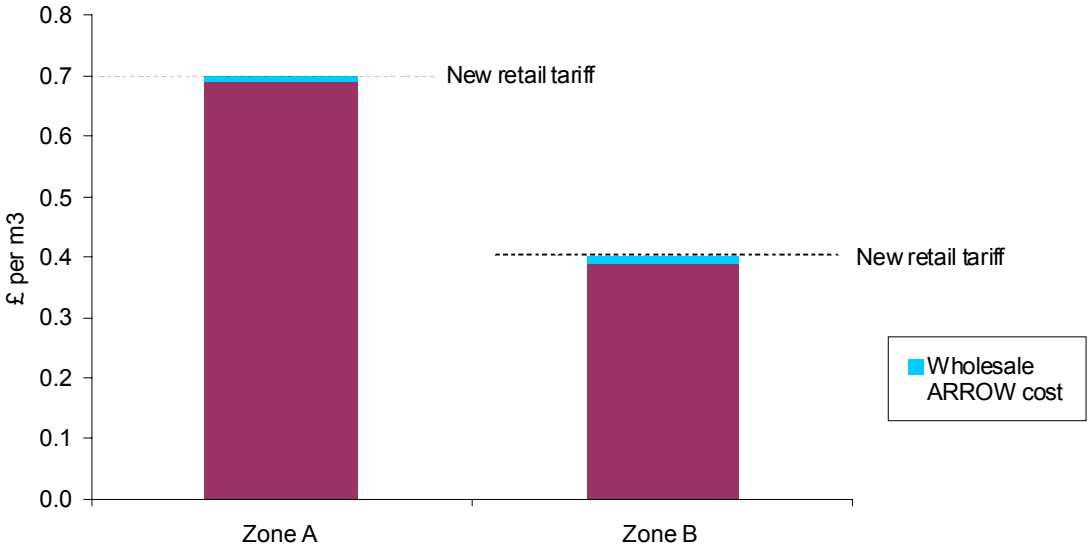
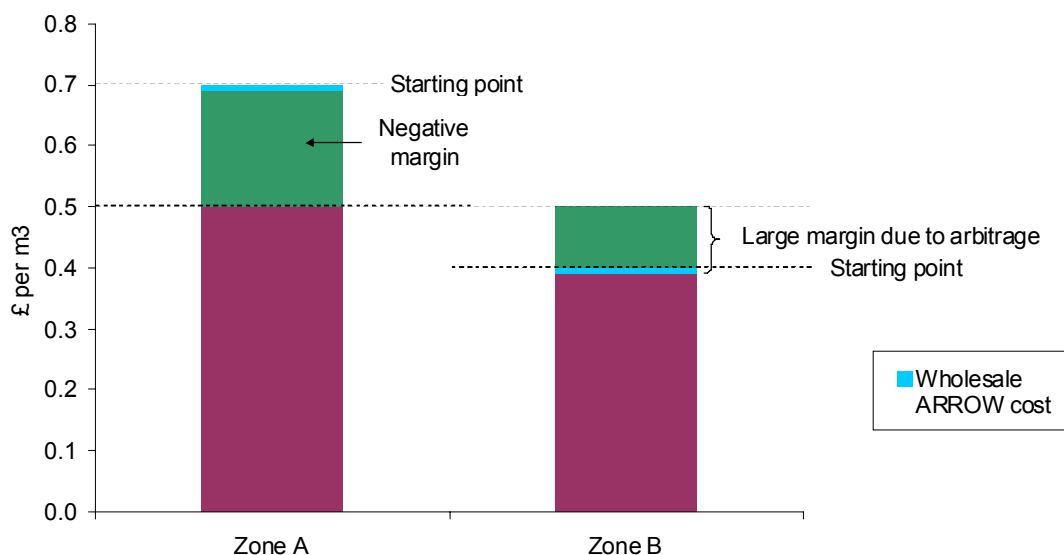


Chart 2 Margin for new entrants with local cost retail price



The only scenario in which there might be an impact on the feasibility of new entry would be if the starting point used for the Costs Principle were based on local costs but appointed water companies continued to set retail tariffs on a geographically averaged basis, as shown in Chart 3. This inconsistency between the retail and wholesale charging regimes would create artificial opportunities for arbitrage in zones with low local costs, allowing entry even by firms which were very inefficient. However, there would seem to be no logical basis on which Ofwat could require appointed water companies to use a local costs starting point for the purposes of the Costs Principle while at the same time refusing to allow them to adjust their tariff structure to a local costs basis.

Chart 3 Margin for new entrants with uniform retail price but local cost starting point for costs principle



This work confirms our view that the Costs Principle is one of the biggest obstacles to the development of competition in the water industry. For the reasons illustrated above, we believe further work is needed to look at possible alternative access pricing mechanisms. Chapter 6 explains more about our consultation in June to gather views on possible options for change that are outside of the current framework in WIA91.

However, in the meantime we can review the “minus” part of the Costs Principle, i.e. those costs that are considered avoidable and thus should be subtracted from the retail starting point to give an access price (ARROW costs). One option is to provide more prescriptive guidance on ARROW costs, including the possibility of:

Wholesale supplies

- To require appointed water companies to provide more detailed reporting about the retail services that they currently provide to customers and those they expect to provide to licensees including:
 - Specifications of the services currently provided to different types of water customers.
 - Analysis of the underlying cost drivers for the services that different types of customers receive.
 - Identification of the nature of and basis for allocating overheads to retail activities.
 - Identification of previous and forecast capital expenditure directly associated with retail activities.

- Estimates of the cost to provide a minimum service to a licensee.

Combined supplies

- To require appointed water companies to provide more detailed forecasts of the costs of providing different levels of additional resources.

These changes would help to clarify what services and functions provided by the appointed water companies are charged for under the current retail price. In turn, that added clarity would help to differentiate between what could be said to be ‘core’ regulatory functions, ‘non-core’ regulatory services and functions, and what could be seen as ‘consultancy’ or ‘non-regulatory’ services. These distinctions could be used by customers and their preferred suppliers to tailor the service requirements from the appointed water companies.

We intend to consult on these changes to the access codes guidance in April.

5.2.2 Access codes guidance – non-price

Proposed changes:

- Further guidance on terms and conditions for access agreements, including on secondary and combined supplies, security deposits and other payment guarantees, termination, application fees, and compliance;
- Guidance on standard paragraphs for WMAs to help to ease negotiations;
- Further promotion of the adoption of customer-specific agreements, as Ofwat already has the power to determine customer-specific agreement disputes

WMAs

We have set out a number of steps in section 5.1 above that we can carry out immediately. We also propose to consult on more specific and detailed access codes guidance on non-price issues. We consider that WMAs take too long to agree. We have so far required new entrants and appointed water companies to negotiate some aspects of WMAs but this has, on the evidence to date, appeared to be unsuccessful. Only three WMAs have been signed since 1 December 2005. We propose to strengthen our access codes guidance on terms and conditions for access agreements, including security deposits, application fees, interest on late payments, termination clauses, confidentiality arrangements, advance payment and dispute resolution.

We will provide guidance on standard paragraphs for WMAs to make negotiations more straightforward. We will also consider the merits of issuing a standard WMA to the industry. We will also more strongly promote the option of moving straight to customer specific agreements, the terms and conditions of which we have the power to determine in response to disputes referred to us by licensees. We will discuss these policy issues with our advisory groups and consult formally on changes to the guidance in late April.

Secondary and combined supplies

We intend to further develop our guidance on secondary and combined supplies, where licensees transport their own water resources (including water bought from a neighbouring undertaker) via an undertaker's supply system for retail to their customers. Changes to our guidance could include for example defining what we mean by "spare" water, examining the scalability of current discounts and ensuring that appointed water companies offer discounts to licensees when deficits exist. Our access codes guidance already contains information on secondary supplies. However, we will be consulting on more detailed, separate guidance on secondary supplies in April.

Supplier of last resort

Customers have expressed concerns that there is no statutory duty on an appointed water company to be a 'supplier of last resort' in the event of licensee failure. In addition to their statutory duties to supply, appointed water companies are free to offer a non-statutory 'stand-by' service to licensees or customers (for which they can charge). But some customers feel they have insufficient comfort about the security of their supply. We will therefore consider how best to address this in order to increase customers' confidence in switching supplier.

We have explained to our advisory groups and to customer representatives that appointed water companies are not always obliged to guarantee supplies for non-domestic purposes. Therefore, the security of such a customer's supply is not contractually guaranteed unless it chooses to pay a premium for that service. Despite this, we believe customers generally consider that in the absence of a 'supplier of last resort', their supply would be more secure by remaining with their current supplier than by switching to a licensee.

Customers who switch are protected to some extent by the 'interim supply duty' (section 63AC), which is explained in our access codes guidance. Where the duty applies, the interim supply shall continue until a supply is made under section 52 or 55 WIA91 or the appointed water company serves notice of disconnection. Such a notice cannot be served within the first three months of the water supply being made.

However, the interim supply duty is not absolute. It does not apply where the provision of the supply would put at risk the appointed water company's ability to meet its existing supply obligations and its probable future obligations to supply water for domestic purposes or require unreasonable expenditure to do so.

Some customers have said that before switching to a licensee they would look for guarantees from appointed water companies that they would take back a customer who switched to a licensee. Generally, at the current stage of market development, we believe it is undesirable for appointed water companies to turn away a returning customer who switched to receive a retail supply from a licensee. We intend to cover this issue in our WSL letter to the industry in April to communicate best practice.

In the case of combined supplies, difficulties can arise in the provision of supplies of last resort. For example, if an appointed water company deferred a capital scheme because a large customer switched to a licensee, the appointed water company might need to invest in additional resources before taking the customer back.

The strategic supply designation process may give some comfort to licensees' customers that they will continue to receive water for domestic purposes if a supply is designated strategic, this duty is set out in section 52 WIA91. Sections 66G and 66H WIA91 allow us to determine whether one or more introductions of water into an appointed water company's supply system by a licensee under section 66B or 66C WIA91 constitute a strategic supply or a collective strategic supply. An introduction of water can be designated as a strategic supply if, without the introduction being made, there is a substantial risk that the appointed water company would be unable to maintain supplies to its own customers as well as supplying the licensee's customers with water for domestic purposes. We may make a determination if an appointed water company asks us to, or where we propose to make a determination that an introduction of water constitutes a strategic supply. We can also consider requests from customers and licensees.

If an introduction is dedicated as a strategic supply and it becomes inappropriate for the licensee to continue to operate as a result of its conduct or the licensee runs into financial difficulties, the licensee will be subject to the special administration procedure in sections 23-26 WIA91. This means that the introduction that had been designated as a strategic supply would continue to be made into the appointed water company supply system.

When considering whether an introduction is strategic, sections 66G(10) and 66H(10) WIA91 allow us only to consider the domestic and non-domestic needs of the appointed water company's own customers and the domestic needs of the combined licensee's customers. Those sections do not allow us to consider the demands of

customers of other licensees, including retail licensees. Defra is aware of this matter and is considering how sections 66G and 66H could be amended

However, we currently consider that a change to the WIA91 is likely to be required to address the issue of 'supplier of last resort' in the longer term.

Compliance with Condition R

In addition to changes in the guidance we will consult on possible changes to appointed water companies' conditions of appointment to strengthen the requirement on them not to misuse information provided by licensees. Condition R states that "Without prejudice to the generality of sub-paragraph (1) above, the Appointee shall not use or disclose information received from a licensed water supplier in the course or contemplation of the discharge of its duties under sections 66A to 66C or in the course or contemplation of its dealings with that licensed water supplier under sections 66A to 66C". We have received some information and anecdotal evidence from licensees and customers that appointed water companies may be misusing information provided by licensees during negotiations about access. These will be followed up and appropriate action taken if necessary. In the light of this, we intend to consider amending this condition, to clarify the obligation on water companies not to misuse information or share it internally with other staff (e.g. account managers) who are not directly involved in the WSL negotiations.

5.2.3 Eligibility guidance

Proposed changes:

- Amend the WSL household and non-household list to redefine some household premises as non-household. This will allow more mixed-use premises to be eligible.
- Change Ofwat's interpretation of "principal use" from an 80/20 split, to premises using no less than 50% of water for non-household purposes. This will allow more mixed-use premises to be eligible.

As stated above, certain eligibility requirements must be satisfied in relation to each set of premises (rather than customers) supplied by a licensee. The eligibility requirements are:

- that the premises are not household premises (as defined in section 17C WIA91);
- the "threshold requirement", that at the time when the licensee first enters into an undertaking with a customer to give a supply, the total quantity of water estimated to be supplied to the premises annually pursuant to the undertaking is not less than 50 MI (50 million litres); and
- that the premises are not being supplied by another licensee.

The biggest issue raised by stakeholders about eligibility is the 50 MI threshold. Any change of that threshold, however, would have to be made by Government by secondary legislation. Stakeholders also raised issues around the types of premises that are or could be eligible and in particular the number of separate sites that could be collectively classed as a single set of premises in order to meet the 50 MI threshold ('multi-site aggregation'). An example often used is whether every branch of the same shop could be aggregated as a single set of premises. As stated in section 1.1 of chapter 1 Defra publicly committed to review the threshold in 2008 and in a letter dated 18 February 2007 the Minister responsible (Ian Pearson MP) said that Defra would consider the merits of bringing forward the threshold review date. We will examine issues relating to a lower threshold in our June consultation paper.

The WIA91 does not define 'premises' for the purpose of assessing eligibility (or any other purpose). Under section 17A(9) WIA91, Ofwat may, with approval of the Secretary of State, issue guidance as to the factors to be taken into account in determining the extent of any premises for the purposes of the eligibility requirements. Ofwat has issued guidance pursuant to that power. Our definition for the purposes of our eligibility guidance follows case law and is consistent with how appointed water

companies treat their large users for the purpose of charging. We have taken the view that premises can include buildings or land and that licensees can only supply customers at individual eligible premises. Our eligibility guidance sets out three broad categories of eligible customer. Our experience of responding to eligibility enquiries to date has shown that these three categories are appropriate. We have not received examples of premises that do not fall within one of the three categories.

The Government was clear in its July 2002 consultation paper that it was not in favour of multi-site aggregation. While there is no specific prohibition on this in the WIA91 and we could change our eligibility guidance with the approval of the Secretary of State under section 17A (9) WIA91, we consider that our guidance and approach to determining the extent of premises remains appropriate. Expanding the extent of 'premises' to include multiple sites would increase the number of eligible customers, but we believe that any substantial increase is more appropriately considered as part of the Government's review of the eligibility threshold. In the light of progress in this respect, we may reconsider our guidance on the extent of premises in our June consultation, including whether multi-site aggregation would create other benefits for customers rather than just allowing them to meet the eligibility threshold.

We could change our guidance to give a small increase in the number of potentially eligible customers. Our guidance contains a list of types of premises that we treat as household and non-household for the purpose of the WSL regime. The guidance also states that the principal use of mixed-use premises will not be as a home where both of the following are satisfied:

- The household part of the premises is dependent in some way upon the non-household part.
- The use of premises is only non-household if the bulk of water supplied is consumed for its non-household use. We consider that for customers above the threshold requirement of 50MI/yr, 'bulk' means at least 80%.

We propose to re-classify some premises currently listed as 'household' as 'non-household' instead. We also propose to change our view of 'bulk' from at least 80% to no less than 50%. This would, in principle, allow more mixed-use premises to be eligible. We will consult on these proposals in April. Primarily, the premises type has to fall within one of the three criteria for a single set of premises. Principal use only applies where the single set or premises has mixed use.

5.3 Options for changing our other guidance

In addition to proposing changes to our WSL guidance, we will consult by the end of this year on changes to our guidance on inset appointments, self-lay and CA98, as set out below.

5.3.1 Inset appointments (consultation on guidance – November 2007)

At this stage we do not consider there is any need or desire to change the current legal framework for inset appointments. There is currently a lot of interest in inset appointments for unserved sites. We recognise that new entrants may seek ‘light touch’ regulation. On the other hand, household customers on new developments have no choice about who becomes their monopoly supplier. We need appropriately robust regulation to protect their interests. With the benefit of our experience of inset appointments over the years, we will look at how we can streamline our processes, taking account of the associated risks. For example, changes to the inset application process we are considering are:

- Securing parent company guarantees to cover the inset applicant in the event of financial difficulties, which might alleviate concerns we might have when assessing the ongoing viability of a proposal.
- Providing an example of how applications should be set out to avoid delays early on in the process;
- More work by the applicant and Ofwat at the pre-application stage to make sure that the application is fit for purpose when it becomes formal;
- Developing policy to address the emerging multi-utility market;
- Working in parallel with the WSL regime, for example considering whether an inset or WSL licence application is more suitable in the case of large users;
- Providing a definitive view on the recovery of infrastructure charges;
- Clearer guidance on the setting of bulk supply prices and terms;
- Separate inset guidance for incumbent appointed water companies; and
- Including up-to-date case studies in the revised guidance.

After consulting stakeholders in June, we will revise our guidance on inset appointments by the end of the year to reflect these changes to our process, depending on responses.

5.3.2 Self-lay (consultation on guidance – November 2007)

We will review our guidance on competition in providing new water mains and service pipes later this year. We will consider allowing contractors to connect service pipes to

an appointed water company's main and self-laid mains to the existing network, to address developers' concerns about delayed connections.

To address the low uptake of self-lay in the south of England, Lloyd's Register's website is to show geographic areas in which each accredited contractor operates. We will then address areas of shortage through increased promotion of self-lay and with policy guidance.

On multi-lay, we will work more closely with Ofgem to address concerns and encourage Lloyds Register to introduce a multi-utility accreditation scheme. In the longer term, we will consider joint guidance with other regulators to promote multi-lay.

5.3.3 Competition Act 1998 (CA98) and regulated market opening (consultation on guidance – November 2007)

CA98 primarily concerns the prohibition of anti-competitive agreements between undertakings, decisions by associations of undertakings or concerted practices, and abuse of dominant positions i.e. abuse by companies with significant market power). However, it is not specifically directed at opening up regulated markets to promote competition.

The other concurrent regulators revised their CA98 guidance following the modernisation of EU competition law in May 2004. However, we have delayed rewriting our CA98 guidance to allow us to take account of the experience of WSL regime and recent case law and to clarify current case handling procedures.

Where a particular agreement or practice falls within the scope of the WIA91 as well as one of the prohibitions in the CA98, we are able to decide whether to use our powers under the WIA91 or the CA98. In such cases we will make use of whichever statutory powers we judge to be the most appropriate to address the specific problem.

As regards the WSL regime, the WIA91, as amended by amongst other things the WA03, has set out a self-contained, sector-specific regulatory regime for market competition. In brief, the WSL regime (and in particular section 66D WIA91) provides a statutory structure for organising access to an appointed water company's water supply system via WSL access agreements. As discussed in section 5.2.1 in simple terms the CA98 Chapter I prohibition does not apply to a WSL access agreement and the CA98 Chapter II prohibition does not apply to conduct (for example fixing prices under the Costs Principle) to the extent to which it is made or engaged in respectively, in order to comply with "a legal requirement".

The WIA91 provides that an access agreement must comply with our guidance (which must include guidance on the Costs Principle) and with the Costs Principle. If an

agreement does not comply with our guidance or with the Costs Principle, we may require the parties to modify or terminate the agreement. Section 66D(9) WIA91 expressly prevents us from exercising in relation to an access agreement, the powers under section 32 CA98 (directions in relation to agreements) or section 35(2) CA98 (interim directions). However the WIA91 also provides, in section 66D(10) WIA91, that we have the power to issue interim measures concerning suspected infringements of the Chapter I or Chapter II prohibitions in relation to “conduct which is connected with” a WSL access agreement.

We will consult stakeholders in November about changes to our CA98 guidance.

6. Options for longer-term changes to competition in the water industry

This chapter explains the need for more work and public debate in order to make decisions on an appropriate future approach to competition in the water industry. Many options in this chapter would require primary legislation, secondary legislation and/or the support of Defra, Parliament and other key players, to implement. We are not aware of any plans to bring forward new legislation for water competition, but we believe it is appropriate to begin discussing these issues now, so the points can be properly debated.

There are many possible changes to the competition regime that might bring benefits to consumers and to the prospects for competition in general. This chapter briefly sets out some of those issues. We have not currently considered these options in detail; however, we intend to consult on them in June, in order to encourage debate.

At the same time as considering a different framework for the future of competition in the water industry and looking for ways to incentivise companies to compete, we must also have regard to our wider duties to:

- Enable efficient water companies to finance their functions.
- Contribute to the achievement of sustainable development.
- Have regard to the interests of various vulnerable groups, including customers on low incomes and customers in rural areas.
- Ensure that customers in similar circumstances pay similar charges, and that any differences in charges properly reflect relevant differences in circumstances.

6.1 Water Supply Licensing

Many stakeholders, including ourselves, have stated that the main two hurdles to WSL competition are the high eligibility threshold level and the Costs Principle.

Appointed water companies currently have little incentive to compete, because one effect of the Costs Principle is that they are financially indifferent to whether they or licensees supply end consumers. We intend to consider whether to recommend to Government changes to appointed water companies' incentives to compete, via an alternative access pricing mechanism. We will also look at what alternative access pricing mechanisms could be suitable for introduction.

Alternatively the Costs Principle could be removed (through new legislation) and a new set of principles established, by which Ofwat could ensure that appointed water companies can finance their functions while at the same time developing an access pricing regime that allowed effective competition from new entrants to develop.

We will also consider whether to recommend a reduction in the eligibility threshold, since a larger market could improve entrants' ability to compete. However a reduction in the threshold is unlikely to be sufficient by itself, and changes to the Costs Principle are likely to be needed in order to make it profitable for licensees to enter the market.

As set out in section 5.2.2 of chapter 5 above, customers have expressed concerns that there is no statutory duty on an appointed water company to be a "supplier of last resort" in the event of licensee failure. We will consider whether it is desirable to propose a change to the WIA91 to address this.

We intend to set out our analysis of the above options and the effects of any suggestions for change, in our June consultation paper. After taking account of stakeholders' views, we will consult in more detail on what, if any, options for change are required, before making any recommendations to Government.

6.2 Cost allocation

Some stakeholders argue that market competition will be stifled until the costs of supplying water to customers are more easily understood and more readily identified.

We consider that there is a need to understand better the value of water and sewerage services, and the costs that companies incur along the chain of supply and intend to initiate work in this area. This cost allocation work will underpin many of Ofwat's priorities, as set out in our forward programme.

6.3 Other ideas for change

In addition to the changes to the WSL regime mentioned above, there are other areas where change could, at least in principle, benefit competition. Some of these issues have been debated in the context of competition in other industries and some of these options were referred to in the Government's 2002 consultation "Extending opportunities for competition in the water industry in England and Wales". We believe it is important to revisit these options. Some options, for example, accounting separation

and tariff policies can be taken forward by Ofwat but the other changes would need to be effected by new primary legislation.

In response to the research conducted by Ofwat and CCWater (see section 2.3), business customers supported the introduction of a national water supply network. We will not be looking at this as an option for the future as it is not necessary to address concerns about security of supply and it would be hugely costly. For more information please refer to the Environment Agency's paper 'Do we need large-scale water transfer for south east England' (September 2006).

We will consider carefully what options should be explored in our June consultation as our work continues and we welcome feedback we receive from all stakeholders to help inform our views. The consultation will be followed by an industry workshop, probably in July. Below is an initial and not exhaustive list of areas which could be considered:

- Exploring accounting separation of functions, including retail functions. This could be addressed initially by changing the structure of the June Return and associated reporting processes. We could also consider total production/ distribution/retail accounting separation, and even structural separation of retail, or retail and production, from distribution (but this would require primary legislation by Government).
- Exploring different tariff policies as part of Ofwat's wider review of tariff strategy. In doing this work, we will also consider the case for Ofwat to pursue regional de-averaging of tariffs.
- Considering including household customers as part of the formal WSL framework for competition. Again, this would require primary legislation.
- Examining the potential for more competition in abstraction rights. Some form of auction-based system for trading abstraction rights, for example, could lead to a more transparent and realistic valuation of water resources (and the impact on the environment of abstractions), and would also allow licensees to obtain abstraction rights that are otherwise unobtainable.
- Looking at the inclusion of sewerage in the WSL regime – some customers' sewerage bills are much higher than their water bills. A specific framework for competition in sewerage services was not included in the WA03 because a market already exists in providing such services, for example in providing on-site sewage treatment. Although the current legislation does not prohibit competition in sewerage services, the desirability of creating a particular legal framework to promote such a market could be explored.

While this is an initial list of possible options to be considered, we welcome suggestions from all interested parties as we formulate our summer consultation paper.

7. Next steps

This chapter sets out the next steps for the review of market competition in the water sector, including an overview of each paper and our timetable. We will publish several papers over the next year to build upon the outcomes of our internal review, to consult on our proposed way forward and, where it is within Ofwat's power, to implement actions to promote a competitive water market. We will talk to the Environment Agency, Defra and other stakeholders. We will work with key players in Scotland and others to consider the competition experience of other countries. Where appropriate and necessary documents will include a qualitative impact assessment.

The proposed timetable for publication of our papers is set out below:

- WSL letter highlighting best practice, asking companies to publish WMAs, raising awareness of raw water availability and encouraging implementation of proposed changes to our guidance. To be published April 2007.
- Consultation 1 will set out options for change within the current framework. The consultation will cover changes we want to make to our WSL guidance. To be published late April 2007.
- Consultation 2 will set out changes to conditions of appointment. This paper will publicly consult on any changes to conditions of appointment that can be made to improve the way the current regime works in the short term. To be published late April 2007.
- We will publish updated WSL guidance following consultation in July 2007.
- Consultation 3 will consider wider changes to the industry. This document will suggest how wider changes to the industry, by way of longer-term changes to our policy or changed or new legislation to improve prospects for competition and to improve regulation. To be published in June 2007.
- Paper 4 will be a published summary of responses to the June consultation, including explanations of why we have decided not to pursue some of the options consulted on. If appropriate, we will issue a follow-on consultation in November 2007, taking account of responses, to propose detailed policy on several options for future competition in the water industry.
- Consultation 5 will consult on changes to the CA98 guidance, inset appointment guidance and self-lay guidance. To be published November 2007.

Appendix 1 Overview of our competition powers and the legal framework of the current competition regime

The framework for competition within the industry is set out in the Water Industry Act 1991 (WIA91). The scope was extended by amendments to the WIA91 in the Competition and Service (Utilities) Act 1992, the Competition Act 1998 (CA98) which took effect from 1 March 2000 and further amendments to the WIA91 introduced by the Water Act 2003 (WA03), the main competition parts of which took effect on 1 April 2005 (our new duties) and 1 December 2005 (WSL regime).

A1.1 WSL regime

The WSL regime (introduced by the Water Act 2003) enables new companies (licensees) to supply water once we have granted them a licence. They can compete by:

- developing their own water source and using the supply systems of appointed water companies to supply water to customers' premises; ('combined supply'); or
- buying water 'wholesale' from appointed water companies and selling it on to customers ('retail supply').

A1.2 Inset appointments

Sections 7 to 9 of the WIA91 state that another company can replace the appointed water and/or sewerage company for a specific geographic area. This applies if one of three criteria is met:

- the customer is a large user (consumes at least 50MI of water a year in England and at least 250MI of water a year in Wales, the 250MI threshold applies in relation to customers of appointed water companies whose area is wholly or mainly in Wales);
- the site is currently unserved (also known as greenfield); or
- by incumbent consent.

A1.3 Self-lay

The term self-lay describes the process whereby developers choose their own contractor to install water mains and service pipes, rather than asking the appointed water company to carry out the work. Under the WIA91 (as amended notably by WA03) if a contractor lays pipes in accordance with the terms of an agreement with an appointed water company then that company must connect those pipes to its supply system and take over responsibility for (adopt) them.

A1.4 Competition Act 1998

We have powers to apply and enforce CA98 in relation to the water and sewerage industry in England and Wales. We can investigate complaints about concerns of anti-competitive conduct where we have 'reasonable grounds' for suspecting an infringement, and we can make decisions about whether the conduct infringes CA98.

A1.5 Other competition tools

EC Regulation 1/2003, referred to as the Modernisation Regulation⁷, took effect on 1 May 2004. It requires national competition authorities of the Member States (of which we are one) to apply and enforce Articles 81 and 82 of the EC Treaty.

The Enterprise Act 2002 includes provision for the enforcement of consumer law, consumer codes of practice, merger control, market studies, strengthens powers under the CA98, criminalisation of cartels, disqualification of directors for breaches of competition law and super-complaints.

We may make market investigation references to the Competition Commission in the water and sewerage sector where it appears that the structure of the market or the conduct of companies or customers is harming competition. When making a reference, we must have reasonable grounds for suspecting that one or more features of the market prevents, restricts or distorts competition in relation to the supply or acquisition of goods or services in the UK (or part of the UK).

7. http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_001/l_00120030104en00010025.pdf

Appendix 2: Glossary of terms

There follows a brief description of some of the terms used in the WSL regime. Readers should refer to Water Industry Act 1991(WIA91) for precise statutory meanings.

Access: The wholesale supply of water by an appointed water company to a licensee for the purpose of making a retail supply of water to the premises of the licensee's customer; and the introduction of water by the licensee into an appointed water company supply system for that purpose.

Access agreement: An agreement between an appointed water company and a licensee for access by a licensee to an appointed water company's supply system pursuant to the Retail Authorisation and/or Supplementary Authorisation.

Access code: A appointed water company's document that sets out all principal aspects of access to its supply system and the terms and conditions on which it will grant access to its supply system by a licensee. The access code comprises the standard terms and conditions common to all appointed water companies and the terms and conditions specific to that appointed water company.

Access terms: The terms under which an appointed water company and a licensee agree access to the appointed water company's supply system.

ARROW costs: Expenses that can be Avoided or Reduced, or any amount that is Recoverable in some Other Way (other than from other customers of the appointed water company) (see section 66E(3) WIA91).

Combined Licence: A Retail Licence with the Supplementary Authorisation, authorising the holder to introduce water into a appointed water company's supply system and to retail that water to a customer's eligible premises (section 17A(6) WIA91).

Combined supply: A supply made pursuant to a combined licence.

Costs principle: As defined in section 66E WIA91.

Defra: Department for Environment, Food and Rural Affairs.

DWI: Drinking Water Inspectorate.

Eligible premises: Premises that satisfy the eligibility requirements in section 17A(3) WIA91. Each of the following three requirements must be satisfied in relation to each of the premises in order for a customer's premises to be eligible.

- The customer's premises must not be 'household premises' (as defined in section 17C WIA91).
- When the licensee first enters into an undertaking with a customer to give the supply, the total quantity of water estimated to be supplied to the premises annually

by the licensee must be not less than 50 megalitres (the “threshold requirement”, section 17D WIA91).

- The premises may only be supplied by one licensee (but may also be supplied by one or more appointed water companies).

Licensee: A company holding either a Retail Licence or a Combined Licence; also referred to as a licensed water supplier.

Multi-utility: This is where one self-lay operator installs more than one utility service to a site (which could include gas, electricity, water and telecommunications), sometimes in a single trench.

Non-potable: Water which is not intended for domestic or food production purposes.

Potable: Water for domestic and food production purposes which is wholesome at the time of supply. This is defined in section 68 WIA91 and section 4 of the Water Supply (Water Quality) Regulations.

Retail authorisation: An authorisation to a company to use a appointed water company’s supply system for the purpose of supplying water to the eligible premises of customers of the company (section 17A(2) WIA91).

Retail Licence: A Water Supply Licence giving the holder the Retail Authorisation, entitling the holder to purchase wholesale a supply of water from the appointed water company and to supply it retail to a customer’s eligible premises (section 17A(4) WIA91).

Supply system: Any water mains and other pipes used for the purposes of conveying water from a appointed water company’s treatment works to its customer’s premises and any water mains and other pipes used to convey non-domestic water from any source to premises that are not connected directly or indirectly to any water mains or pipes connected to those treatment works. This term is defined in section 17B(5) WIA91.

Water Supply Licence: A licence granted to a company giving it the Retail Authorisation, or both the Retail Authorisation and the Supplementary Authorisation.

Appointed water company: A company appointed under the WIA91 to provide water services to a defined geographic area and which owns the supply system and other infrastructure.

WIA91: The Water Industry Act 1991 (as amended by amongst other things the Water Act 2003).

Wholesale supplies: Supply of water to a licensee by an appointed water company for the purposes of retail by the licensee to its customer’s premises.



Ofwat, Centre City Tower
7 Hill Street, Birmingham B5 4UA

Phone: 0121 625 1300 Fax: 0121 625 1400
Website: www.ofwat.gov.uk
e-mail: enquiries@ofwat.gsi.gov.uk

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