

Consultation on market competition in the water and sewerage industries in England and Wales



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Executive summary

The purpose of this consultation is to raise for debate a range of options for introducing effective market competition into the water and sewerage sectors in England and Wales.

In April 2007 we published our Outcomes paper on the conclusions of our internal review of the competition regime and we are taking forward work based on the conclusions set out in that paper. For example, we have consulted on the areas that it is possible for Ofwat to change in the short term to improve the functioning of the current water supply licensing regime, via changes to our water supply licensing (WSL) guidance.

In general, those who responded to the Outcomes paper welcomed the review of competition, although respondents were keen to ensure that the review is consumer focused. The responses to the paper are set out further in chapter three.

In addition to the steps we have already considered this paper starts a wider review of competition in the water and wastewater sectors to enable us to look at other options for promoting the development of effective market competition.

- First, we describe some background market analysis work that we will carry out over the coming months to provide a useful framework for potential changes and proposals.
- Second, we consider some options based on developing the existing regime. Some of these can be taken forward by Ofwat relatively quickly. Many, however, would require the support of Government and others, and also changes in primary or secondary¹ legislation to implement. Clearly these would take longer.
- Third, we consider some more substantial changes to the existing market structure and regulatory regime that could be considered if they promote effective competition in the interests of customers. Again, many of these would require support of Government and other stakeholders, as well as changes to legislation.

Amending legislation is a slow process and therefore pursuing any options that require legislative changes will require support of Government and the responses to this consultation will feed into any recommendations we make in that regard. We will work with the Department for Environment, Food and Rural Affairs (Defra), other Government agencies and the National Assembly for Wales (“the Assembly”) while developing our approach.

We have already shared our position with colleagues at Defra, this includes the work we set out in the Outcomes paper. We will continue to work with Defra to ensure that whilst consulting on the issues set out in this and subsequent papers we are

¹ Delegated legislation (sometimes referred to as secondary legislation or subordinate legislation) is law made by ministers under powers given to them by parliamentary acts (primary legislation) in order to implement and administer the requirements of the acts.

moving towards the aims as set out in the paper to improve the current competitive regime.

This paper asks a number of questions around the options for changes and we are seeking the views of stakeholders on these. The questions are set out in chapters four and five.

We will keep stakeholders involved in the process as we move forward. This will include a workshop to be held on 20 July to introduce and debate the issues raised in this consultation. We will take account of that discussion, as well as considering formal responses to this initial public consultation, in developing the next steps. However, as this is an initial consultation we expect to consult again on any specific policy proposals that we intend to promote. Our timetable going forward is set out in chapter six and a timeline illustrating Ofwat's work on all of the projects set out in this paper is included as annex one.

1. Background

On 1 December 2005 the new WSL regime as introduced by the Water Act 2003 (WA03) came into force. It enables customers who are likely to buy at least 50 megalitres (Ml) of water a year (approximately 2,200 businesses) to switch to a licensed water supplier. Since then, Ofwat has sought to develop the new regime. However, twenty months on, we are concerned that competition has not developed in water supply licensing. We expressed our concerns about delays in MD212 'Delays in the WSL Regime' in April 2006, and started a process of examining why competition has not developed under the WSL regime last autumn. This process has included looking at options to remedy the situation.

The development of effective market competition will promote and protect the interests of consumers by delivering sustainable benefits in terms of choice, price and quality of services. While comparative competition and regulation have delivered much improvement in these areas, regulation is always a second-best solution where competition can be effectively developed. Competition can build on the success of the comparative regime to date and also has the potential to stimulate innovation better than regulation.

Our approach to competition must also have regard to Ofwat's wider duties under the Water Industry Act 1991 (WIA91), notably our obligation under section 2(2A) WIA91 to exercise and perform our powers and duties in the manner we consider is best calculated (amongst other things) to further the consumer objective.

We also need to have regard to the Government's policies and objectives on competition, as set out in its 2002 consultation, "Extending Opportunities for Competition in the Water Industry in England and Wales". In it, Defra and the Assembly set out the benefits to customers that they expected would be delivered by competition:

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

The Government believes that increasing competition can be beneficial, but noted that competition is not an end in itself and that the potential benefits must be balanced against the Government's wider objectives for the water industry, which are to:

- protect public health;
- protect and improve the environment;
- meet the Government's social goals; and
- safeguard services to customers.

These objectives are still valid, although Ian Pearson MP (previously Minister for Climate Change and the Environment) has said² that Government is committed to a greater level of competition, and is willing to review all the elements of the regime, including the eligibility threshold and the Costs Principle, to ensure it delivers.

1.1 The review of market competition

We began our internal review of market competition in autumn 2006, to:

- assess the scope and opportunities for market competition in light of the lack of progress with the WSL regime;
- identify possible improvements to the current regime; and
- evaluate Ofwat's existing policies on competition and tariff setting, highlight their effects and recommend ways in which those policies might be changed.

While the review focused primarily on the WSL regime, we also considered inset appointments and self-lay.

We published the outcomes of the internal review of competition on 4 April 2007³ (the 'Outcomes paper'). We concluded that there were some small changes we could make quickly to refine our existing policy but that we would need to tackle other obstacles to the development of effective competition, such as the mechanism for setting access prices⁴, by pursuing changes in legislation. Our Outcomes paper included our plans to do more work and engage in further public debate before deciding upon our future approach. Respondents generally welcomed the concept of the review. There were differences of opinion, however, regarding the interpretation of the Costs Principle; and while there was some support for a reduction in the eligibility threshold, there were concerns that this alone may not remove barriers to entry. Chapter three provides more details of those responses.

Since publishing the Outcomes paper, we have made progress on the changes we can make now to improve the WSL regime. On 2 May 2007 we published consultations on changes to Ofwat's existing WSL guidance⁵ and on secondary supplies guidance⁶. We have received 23 responses to these consultations and plan to publish a summary of those responses together with the guidance documents at the end of July 2007. On 2 May 2007 we also published a WSL letter (03/07) to provide interim guidance to appointed water companies and others on best practice.

² Speech by Ian Pearson MP to the IEA 'Water 2007' conference, 25 June 2007.

³[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/\\$FILE/competitionreview_070404.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/$FILE/competitionreview_070404.pdf)

⁴ 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.

⁵[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_guidance020507.pdf/\\$FILE/wsl_cons_guidance020507.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_guidance020507.pdf/$FILE/wsl_cons_guidance020507.pdf)

⁶[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_secondarysupplies020507.pdf/\\$FILE/wsl_cons_secondarysupplies020507.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_secondarysupplies020507.pdf/$FILE/wsl_cons_secondarysupplies020507.pdf)

In addition to the work outlined above we, in conjunction with the Consumer Council for Water, have also conducted market research into business customers' views on competition in the water industry. On 27 April 2007 MVA consultancy presented the key findings and conclusions from the research⁷. The research found that:

- 75% of eligible customers were aware of competition;
- 84% of respondents were very supportive or quite supportive of competition in the water industry; and
- 61% of respondents were either likely or quite likely to change supplier in the right circumstances.

However, 47% of respondents said they were 'neither satisfied nor dissatisfied' with current water prices, and 41% were neither 'confident nor not confident' with the WSL regime. This implies a lack of engagement that needs to be addressed.

We have also decided that a wider market analysis would be useful to support the implementation of recommendations. The scope of the market analysis project is set out further in chapter two of this paper.

In other utility markets, customers benefit from being able to choose their supplier and the type of service they wish to receive. We do not consider that water and sewerage customers should be denied those benefits, although we do explain later in this paper where we believe the water and sewerage industries are different from other utility industries. In this paper we consider the competition regimes in other utility industries in England and Wales (notably electricity, gas and telephony), and the water industry in Scotland and New South Wales, Australia. Market competition has not been introduced into the water and sewerage industries in most countries. We have therefore focused our research on the comparators that we consider are most relevant to this industry.

This review is separate from, but linked to, our project to increase our understanding of the value of water and sewerage services and the costs that water undertakers incur at each stage of the chain of supply. This is one of the workstreams referred to in our 'forward programme' (April 2007)⁸. A better understanding of these values and costs will enable us and others to see more clearly what opportunities there may be for effective competition. In addition, this work will contribute to the development of greater transparency in costs. This may enable customers to choose the product with the appropriate service levels and components they want at a price that reflects the costs of those components.

⁷[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/comp_slides080507.ppt/\\$FILE/comp_slides080507.ppt](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/comp_slides080507.ppt/$FILE/comp_slides080507.ppt)

⁸ [http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/fwdprog07-08_09-10.pdf/\\$FILE/fwdprog07-08_09-10.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/fwdprog07-08_09-10.pdf/$FILE/fwdprog07-08_09-10.pdf)

1.2 Purpose and structure of this consultation

The consultation is structured as follows.

- Chapter 2 sets out the scope and timetable for the market analysis project as well as some initial market observations.
- Chapter 3 sets out a review of the responses to the Outcomes paper
- Chapter 4 explains the options for change to the current market competition regime.
- Chapter 5 sets out some more fundamental ideas for change.
- Chapter 6 sets out the next steps in our review of competition.
- Annex one illustrates the timescales for all of the projects set out in this paper.

This consultation forms part of our review and aims to raise for debate a range of options for introducing effective competition into the water and sewerage sectors. Some of these options, particularly those in chapter five, go far beyond the current competition framework and could, if implemented, have wider implications for all consumers.

We indicate which changes we support now and those where we have yet to take a view. After taking account of responses to this consultation, we plan to consult by the end of the year on more detailed policy proposals for the current competition regime (as set out in chapter four). We will also by then give an update on our work on more fundamental changes to the competition regime and on the market analysis project. This and other workstreams will run in parallel to the ongoing work on the review. In spring 2008 we will consult on our firm proposals for other changes to the competition regime and the findings of our market analysis project. However we need stakeholders' views to shape the way forward and we ask for responses to this consultation to assist with our work going forward.

1.3 Responding to the consultation

We are holding a discussion forum in Birmingham on 20 July 2007 to set out the issues raised in this paper and to encourage all interested parties to debate them. The discussion forum is being held close to the publication of this paper to focus and stimulate debate. The initial presentation at the discussion forum will set out an overview of this paper. Invitations have already been sent to industry stakeholders. Please contact us if you have not received an invitation but would like to attend.

We invite your views on the questions and options that are set out in this paper. We are aware that some of the issues considered in this paper may have already been covered by other papers and that stakeholders may already have made representations to Ofwat on some of those issues. However for the sake of completeness and to give all interested parties the opportunity to comment we have set out our views on all aspects of the review going forward. If you have already commented on a particular issue and do not wish to comment again please refer to that correspondence in any response you choose to make.

Please send your written responses by 28 September 2007 to:

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Birmingham
B5 4UA

Or by e-mail to: hayley.purcell@ofwat.gsi.gov.uk.

If you wish to discuss any aspect of this paper, please direct your enquiry to Hayley Purcell in the first instance.

Representations and objections will be placed in our library and on our website and made available to the public unless the person making those representations/objections has, in so doing, clearly indicated that he did not wish this to happen. In general, Ofwat will seek to honour any requests for representations/objections to be kept confidential. There may, however, be circumstances in which representations/objections may have to be disclosed notwithstanding the wishes of the makers of those representations (for example, if disclosure is required under the Freedom of Information Act 2000 or in legal proceedings).

1.4 Relevant documents

Readers of this paper may find it useful to revert to the list below of other relevant documents that have been and will be published by Ofwat and others in relation to our review of market competition.

Published documents

18 November 2006 – letter to Ian Pearson MP

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/IanPearson301106.pdf/\\$FILE/IanPearson301106.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/IanPearson301106.pdf/$FILE/IanPearson301106.pdf)

Regina Finn's letter to Ian Pearson setting out our concerns about lack of progress on WSL competition and our view that the major constraints were the high threshold and the Cost Principle.

4 April 2007 – the Outcomes paper

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/\\$FILE/competitionreview_070404.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/$FILE/competitionreview_070404.pdf)

The Outcomes paper set out the outcomes of our internal review which included some immediate changes to the WSL guidance, longer term changes to the current regime and some wider options for change.

2 May 2007 – WSL letter – WSL guidance consultations

<http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/wsl0207>

WSL letter which set out the purpose of the consultations on the changes to the WSL guidance and the secondary supplies guidance.

2 May 2007 – WSL guidance consultation

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_guidance020507.pdf/\\$FILE/wsl_cons_guidance020507.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_guidance020507.pdf/$FILE/wsl_cons_guidance020507.pdf)

Consultation on changes to sections of the WSL guidance documents as set out in the Outcomes paper to improve the short term functioning of the WSL regime. Closing date for responses was 1 June. Final guidance will be published by 31 July 2007.

2 May 2007 – Secondary supplies guidance consultation

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_secondarysupplies020507.pdf/\\$FILE/wsl_cons_secondarysupplies020507.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/wsl_cons_secondarysupplies020507.pdf/$FILE/wsl_cons_secondarysupplies020507.pdf)

Consultation on Ofwat's new guidance on how to manage situations where a licensee applies for a secondary supply to supply its customer. Closing date for responses was 1 June. Final guidance will be published by 31 July.

2 May 2007 – WSL letter – WSL best practice

<http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/wsl0307>

WSL letter setting out best practice for completing wholesale master agreements.

4 July 2007 – MVA business customer research

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/setting_strategic_direction.pdf/\\$FILE/setting_strategic_direction.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/setting_strategic_direction.pdf/$FILE/setting_strategic_direction.pdf)

Joint market research conducted by CCWater and Ofwat into business customers' views on competition in the water industry

Future documents

July 2007 – Updated WSL guidance documents and the secondary supplies guidance.

This will provide new secondary supplies guidance and updated WSL guidance which will take account of comments received during the consultation process.

October 2007 – Ofwat's draft forward programme.

The forward programme sets out Ofwat's work for the next year. It will contain an update on the review of competition and the market analysis project.

November 2007 – Consultation on changes to the CA98 guidance (OFT 422) and the inset application guidance.

Consultations on changes to the CA98 guidance in the light of the review and changes to legislation and on the inset appointment application process.

December 2007 – Response to comments made on this consultation paper and next steps, including changes to the current competitive regime.

This document will respond to any comments made in response to this consultation paper and will set out those areas of the current competition regime that Ofwat proposes to develop and change so as to promote competition in the interests of customers.

2. Market analysis

The provision of water and sewerage services in England and Wales is potentially made up of a number of markets, both from a product and a geographic perspective. The existing WSL regime has been developed to open up a specific sub-set of the markets – the supply of water to customers likely to use at least 50MI of water a year, approximately 2200 customers. While much of this consultation paper sets out options for the further development of the WSL regime, we consider that it is useful to review the wider market for water and sewerage services.

This analysis will identify more clearly the key characteristics of the market (or markets), the current level of competition in those markets and features of the relevant market that tend to restrict or prevent market entry and/or limit the extent of competition between existing players. Our analysis is likely to involve an assessment of the impact of the existing framework for water and sewerage services. For example, the geographic nature of appointments of water and sewerage and water only undertakers⁹ means that each water undertaker in practice has a monopoly on the supply of certain goods/services in a given area. We will also consider the extent to which measures of profitability (for example, internal rate of return and return on capital employed) can be used to make inferences about the competitiveness of these markets and which of these measures provide the most meaningful insights.

This work will be used, along with the responses to this consultation, to help inform Ofwat's proposals on how competition in the water and sewerage sectors can be promoted in the interests of consumers.

2.1 How we will conduct the analysis

We will broadly describe the markets which exist within the water and sewerage sectors, and identify those which we should focus on for the purposes of this project. This work will be based on information already held by Ofwat so as to avoid placing any unnecessary information burden on market participants. However, having carried out the initial work, if we identify any gaps in our information we will then need to gather that information directly from stakeholders.

While we will be contacting key parties directly (for example water undertakers, new entrants and business customers), we invite those who have an interest in the outcome of this market study and are likely to be able to contribute, to register their interest with us. This means that you may be asked for information and your opinions during our information gathering phase and subsequently.

⁹ Unless otherwise stated in this paper we refer to water and sewerage and water only undertakers collectively as water undertakers.

We are also asking interested respondents to submit views on the possible market definitions and assessments of competition in those markets in response to this paper.

If you are interested in being included in our information gathering exercise, please send your details to us using the contact details set out in section 1.3.

2.2 Initial market observations

We set out below some initial observations on the markets as a guide to respondents. This is solely for the purposes of consultation and to stimulate discussion. This should not be considered to take the place of a formal market definition and our initial observations are likely to change as we explore the markets more fully.

The broad market comprises the provision of water and sewerage services in England and Wales. The two key dimensions for the definition of a market are what the **product(s)** is/are, and the **geographic** area in which the products are supplied. Put in very simple terms, the products that should be included in the relevant market, and the geographic boundaries of that market, are determined by the extent to which customers can readily switch to substitute products, or suppliers can readily switch their facilities between the supply of alternative products. Market definition therefore looks at 'substitutability'. In addition to the product and geographical dimensions, there is often a temporal dimension to any given market (for example, peak and off-peak or seasonal provision).

- **Product market**

There may be separate but linked markets for water services and sewerage services in England and Wales. In the water market, the supply of potable and non-potable water may be different but related markets. Within these broad classifications there are likely to be further sub-divisions, for example there may be a separate market for the supply of water to customers eligible under the WSL regime.

- **Geographic market**

The geographic market for the supply of water and sewerage services could be a series of regional markets rather than a single national market. This is either because of the geographic definition of water undertakers' appointments or because the supply of water is a local or regional service in nature. Alternatively, if the WSL regime is considered, since the WSL regime covers the whole of England and Wales the geographic market could be considered as a national market by virtue of the single legal framework, at least for this group of customers. There is also the possibility of there being a series of linked markets; for example, the provision for secondary supplies under the WSL regime may be linked to the provision of wholesale supplies by primary undertakers.

Some of the retail services that we will consider when looking to define the possible markets for the purposes of this analysis are set out below (this is a non exhaustive list).

1. Water supply: potable water and non-potable water. Potable water to household customers and potable and non-potable to non-household customers (depending on demand and access to a non-potable supply).
2. Access account services in relation to water supply. For example, different ways of paying bills and updating meter readings.
3. Extra services and products for existing customers in relation to water supply. For example, services for customers with special needs, analysis of water quality, water sampling and water quality testing.
4. Services for new customers in relation to water supply.
5. Additional services for business customers in relation to water supply. For example bill analysis, bill verification, water asset maintenance and leak detection.
6. Sewerage services for both household and non-household customers. For example, basic sewerage service, the treatment of the sewage, and sewage flooding services.
7. Additional services for business customers. For example, pre-treatment services for trade effluent.

We also intend to consider other services such as:

- Wholesale supply of water for resale (potable or non potable).
- Bulk supplies.
- The market for water abstraction rights.

The services set out above could each constitute a separate product and/or geographic market, or may form part of larger markets linked to other products and services provided. This market analysis is a separate exercise from market definition in competition law cases which is conducted on a case-by-case basis.

2.3 Next steps

We will issue updates on the progress of the market analysis project as appropriate.

2.4 Timetable

Timeline	Activity
July to September 2007	Initial analysis by Ofwat based on existing information
September to October 2007	Information requests to key stakeholders if necessary to fill information gaps
September to October 2007	Meetings with key stakeholders if appropriate
Late September	Water undertakers
Early October	Entrants
Early October	Customers
Late October	Interested third parties
November to December 2007	Publish update and next steps on market analysis work

3. Responses to the Outcomes paper

This chapter sets out the responses we received to MD222 (4 April 2007), which included the Outcomes paper. We only received ten responses in total: eight from water undertakers, one from a licensee and one from another respondent¹⁰. Although this was not a consultation but an invitation to comment we had anticipated more responses to our initial publication setting out our proposals in the review of competition, particularly in the light of the calls from many stakeholders to improve the competitive regime. We do not consider that the ten responses received are a true and complete reflection of the position in the industry and would like to encourage the involvement of stakeholders going forward so that all views are accurately reflected in our work programme. Given the small number of responses, we will not issue a separate responses document for the Outcomes paper, however responses have been taken into account in our approach and are set out in the relevant sections of this paper.

3.1 The Costs Principle

The Costs Principle was the most contentious issue with most respondents. Two respondents disagreed with Ofwat's position (as set out in the Outcomes paper and in WSL 01/07) that under the legislation we have no power to interpret the Costs Principle as anything other than "retail-minus". Two other respondents questioned the need for legislative change and one respondent noted that alternative models to the Costs Principle could lead to the unwinding of cross-subsidies. One respondent agreed that there are merits to reconsidering access pricing under the WSL regime. Another respondent agreed that the Costs Principle may have deterred entry, but considered that did not necessarily mean that the promotion of effective competition had been frustrated.

3.2 Changes to the access codes guidance

Respondents welcomed some of the proposals set out in the amended access codes guidance. However, three respondents raised concerns about the cost burden to water undertakers of providing more information to Ofwat. Given that the changes to the access codes guidance are small, one respondent questioned the benefits of the changes when compared with the additional costs water undertakers would incur.

3.3 Eligibility threshold

Only three respondents considered the proposal to reduce the eligibility threshold. Of these, one supported our proposals and two raised doubts about the effectiveness of a reduced threshold. One respondent suggested that as the savings for smaller customers (by volume) would be smaller than the incentive for those customers to switch would also be lower.

¹⁰ Respondents: Aquavitae UK, WaterUK, Albion Water, Northumbrian Water, Mid Kent Water, Thames Water, Severn Trent Water, Welsh Water, Anglian Water and Yorkshire Water.

3.4 General comments

Many respondents considered that the review of competition should focus on the customer perspective and how competition can further customers' interests.

One respondent stated that we should take a more 'competitive' view of inset appointments to allow developers more choice, for example by encouraging more innovation.

Another respondent stated that we should focus on competition in combined supplies as the cost savings are potentially greater than those under the retail element of the regime.

Respondents also raised issues about the benefits of changing the current WSL guidance, given that the effects are likely to be limited.

4. Options for change to the current competition regime

In this chapter we explain some approaches to competition that we could consider taking forward under the current regime if these proved to be appropriate. In arriving at these options, we have considered the competition regimes in other utility industries in England and Wales, and the water and sewerage industries in Scotland and New South Wales, Australia¹¹. We have focused on Scotland and Australia because they are amongst the only water industries (besides England and Wales) which are introducing competition in water and/or sewerage. We provide our initial views on the possible costs and benefits of each approach to competition and say whether, on the basis of our work so far, we support each option or hold a neutral view.

All options are presented so as to provide an opportunity for as wide a range of stakeholder input as possible. We acknowledge that many of these options would require changes in primary legislation, which would clearly need time and support from Government, Parliament and other stakeholders to implement. Respondents may wish to bear this in mind in their responses. However, we clearly state how each option could be implemented if it were appropriate to do so.

4.1 Water supply licensing

We believe that two significant obstacles to WSL competition are the Costs Principle and the high eligibility threshold. We explained our reasons for this view in sections 1.4 and 3.1 of the Outcomes paper.

4.1.1 Approach to access pricing

Current position

Under current legislation, WSL access prices must be set in accordance with the “Costs Principle” (as defined in section 66E WIA91). The Costs Principle can be summarised as follows:

Access price = any expenses reasonably incurred in providing access + retail charge
– ARROW costs

ARROW costs are defined as expenses that can be **A**voided or **R**educed, or any amount that is **R**ecoverable in some **O**ther **W**ay (other than from other customers of the water undertaker). To give an example, ARROW costs would include any costs that the incumbent avoids as a result of no longer having to provide account management services to a customer who switches to a licensee.

¹¹ Water and sewerage competition in other states, such as Queensland and Western Australia, is not as advanced but is being considered actively.

The Costs Principle is a version of a pricing methodology known as “retail-minus” in which access prices are calculated by subtracting avoidable costs from the incumbent’s retail charge.

The indicative access prices that water undertakers published in August 2005 suggest that the Costs Principle produces little discount on retail tariffs for entrants requesting wholesale supplies (under section 66A WIA91). Large discounts could, in theory, be available in a small number of locations for entrants providing combined supplies (under sections 66B and 66C WIA91). As we said in WSL 08/06 ‘Indicative access prices’ (10 July 2006) we do think it would be worthwhile to require water undertakers to update their indicative access prices later this year. We will scrutinise these and make them available to entrants.

The Outcomes paper described modelling work that we carried out to explore the feasibility of new entry by licensees requesting wholesale supplies under the Costs Principle. The results of this modelling 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 outside the WSL regime (ie, the concept of a wholesale supplier of services to retailers rather than end consumers). This is likely to introduce additional costs, particularly transactions costs between undertaker and licensee;
- the Costs Principle requires the licensee to pay all of these new transaction costs without the possibility of reducing other costs and inefficiencies that are currently embedded in the retail price; and
- the licensee must also pay the incumbent’s unavoidable retail costs as well as its own retail costs.

Hence, a key conclusion of our analysis to date is that the Costs Principle remains one of the barriers to the development of effective competition in the water sector.

Other countries and utility industries

Water - Scotland

The sharing of a single water network by several water suppliers (known as common carriage) is prohibited in Scotland and competition is limited to retail supply. In its Final Determination, the Water Industry Commission for Scotland (WICS) set retail charge caps and a provisional wholesale charge cap. Going forward the Commission will set only wholesale charge caps for retailers to non-household customers. The Commission will continue to set retail charge caps for household customers. The Commission will also decide whether to continue to set the level of “default tariffs” in future. These tariffs are set under a licence condition.

The wholesale price caps limit what Scottish Water (the wholesaler) can charge licensed retail service providers. The wholesale charge cap was derived by deducting the retail gross margin for licensees from the total non-household revenue allowed to Scottish Water per year. The retail gross margin includes all costs of retail activities, such as operating expenditure, current cost depreciation, financing costs (including a normal profit) and taxation. The WSL regime in England and Wales is

dictated by the Costs Principle, where the margins depend on costs that can be avoided by the water undertaker. The WICS worked with Scottish Water to develop an appropriate wholesale charging framework. Wholesale and default retail tariffs for 2008-09 are already available in draft form. The tariffs for 2009-10 will be published shortly. Prices and margins are transparent and do not require the potential entrant to negotiate with Scottish Water.

Water – New South Wales, Australia

The cornerstone of the New South Wales *Water Industry Competition Act* 2006 is the primacy of commercial negotiations. As such, any pricing approach that both parties can reach agreement on is supported under the regime so as to avoid unnecessary distortions of market negotiations. In the event that commercial negotiations fail, the New South Wales Independent Pricing and Regulatory Tribunal (IPART) has been appointed as the independent arbitrator and has the power determine the access price. Section 41 of the Act sets out that in the arbitration of access prices IPART must have regard to the following factors:

- the price of access should generate expected revenue for the service that is at least sufficient to meet the efficient costs of providing access to the service, and include a return on investment commensurate with the regulatory and commercial risks involved,
- the price of access should allow multi-part pricing and price discrimination when it aids efficiency,
- the price of access should not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent to which the cost of providing access to other operators is higher,
- the price of access should provide incentives to reduce costs or otherwise improve productivity.
- These principles must be implemented in a manner that is consistent with any relevant pricing determinations for the supply of water and the provision of sewerage services, including (where applicable) the maintenance of “postage stamp pricing” (that is, a system of pricing in which the same kinds of customers within the same area of operations are charged the same price for the same service).

Electricity

Offer introduced domestic electricity supply competition from September 1998 to May 1999, following the introduction of competition into the domestic gas market between 1996 and 1998. Ofgem continued to regulate the prices and quality standards of electricity suppliers until they considered that competition was sufficient to meet their principal statutory objective of protecting the interests of consumers, having regard to their other duties, including the protection of vulnerable groups. Ofgem ceased regulating electricity prices in 2002.

In the UK electricity market charging methodologies have been produced by each distribution network operator since April 2005 following a modification to the distribution licence in July 2004. Charging methodologies are designed to provide

transparency over the basis for charging and have to comply with certain obligations in standard condition 4 of the distribution licence. These include the principles of cost reflectivity and facilitating competition.

Gas

In April 1996 the domestic gas market (that is, all customers consuming less than 2,500 therms a year) in the West Country was opened up to competition, followed by phased introduction of competition in other areas. In February 1997 British Gas plc demerged into BG and Centrica. For the period up until March 2000, Centrica had four separate price controls covering gas supply (including meter reading) for:

- direct debit;
- prompt payment; and
- standard credit and prepayment domestic customers.

In December 2000 Ofgem issued initial proposals for the removal of Centrica's price caps for domestic gas customers.

In May 2005, a Uniform Network Code was introduced that made it easier for companies other than National Grid to own gas networks. Gas transportation charges are derived in relation to price control formulae, which are set by Ofgem. These formulae set the maximum revenue the National Grid National Transmission System can earn from transporting of gas. Should National Grid National Transmission System earn more or less than the maximum permitted revenue in any formula year, a compensating adjustment is made in the following year. Where a significant over- or under-recovery is anticipated within a year an adjustment to charges may be made during the year.

Since April 2002 the price control has been divided into Transportation Owner and System Operator controls. Transportation charges are split to reflect these price control arrangements. For the Transportation Owner revenue, the target is to recover 50% from exit capacity and 50% from entry capacity. Exit capacity charges reflect the estimated long run marginal cost of developing the system to meet a sustained increase in demand. Charges for entry capacity are not fixed but are determined by auctions that apply to all system entry points. For system entry capacity, the reserve prices for the auctions are based on the Unit Cost Allowance for each existing entry point as set out in the National Grid National Transmission System Gas Transporter Licence.

There are a variety of access pricing methodologies used in other countries and industries and we propose to consider these further as part of our review.

Options

This consultation does not recommend a particular approach to pricing but outlines the features of any access pricing regime that we would look to put in place. Our approach is guided by the need to balance Ofwat's overarching duties and we are of the view that to do this there must be changes to the existing access pricing regime.

The regime at present protects incumbent water undertakers fully from the financial impacts of entry by licensees. It also does not disrupt the existing retail pricing structure. This pricing structure includes regional averaging (thus some customers in one region within an appointed area may cross-subsidise others in the same group of customer, in another region). With regard to prices to different groups of customers, Ofwat has regulated retail prices in order to drive them to a broadly cost reflective level. However this has generally been done in an incremental and reactive way and it is possible therefore that there is not full cost reflectivity in groups of tariffs.

In general, the existing regime, in seeking to preserve the status quo, appears to frustrate the potential for efficient new entry. We believe that this is not in customers' long term interests.

We believe that it would be appropriate to develop an access pricing regime that better reflects the underlying cost of access and is better designed to aid new entry and the development of effective competition. Given the need to explore fully the most effective access pricing regimes, and the fact that it may be necessary to tailor approaches to particular circumstances (for example, to have different access regimes depending on the services that a new entrant wanted to buy), we consider that it would be appropriate for the relevant legislation to set out clearly the policy framework for the development of competition and to charge Ofwat as the economic regulator of the sector to implement access pricing regimes that meet those principles.

Those principles could include:

- cost reflectivity;
- entrants to be required to only pay for the services they reasonably require (unbundling) and receive;
- non-discrimination between an incumbents' own notional downstream arm and its downstream competitors;
- efficient operators to recover their reasonably incurred costs for the provision of the services; and
- incumbents to be exposed to market risks and incentives for services that are not part of the core monopoly.

There is a range of options for access pricing, which will support these principles to differing degrees. In particular, retail-minus and cost-plus approaches can bring different benefits and consequences. We think it is important to consider if, when and how these approaches can help to deliver a regime that supports the above principles appropriately.

Perhaps subordinate to this is consideration of:

- the advantages and drawbacks of using average cost and marginal cost approaches;

- the need to consider the short-run and long-run costs; and
- the balance between the benefits from more locally cost-reflective pricing and the advantages of geographic averaging.

Summary

- Changing the Costs Principle would require a change in primary legislation.
- We consider that the Costs Principle sets out an access pricing method that does not facilitate the development of effective competition.
- We consider that the most appropriate change would be to set out in legislation the principles that should apply to any access pricing regime and require Ofwat to develop the appropriate access pricing methodology in line with them.

Consultation questions

1. Do you agree that the current access pricing regime inhibits the development of effective competition? If not, please explain why and how you consider the current regime should be applied (you may wish to refer to our Outcomes Paper¹²).
2. Do you support the suggestion that the principles governing the access pricing regime should be set out in legislation and that we, as the economic regulator should develop the detail?
3. In considering appropriate access regimes:
 - do you think there should be different access pricing regimes for different parts of the supply chain? If so why and for what parts?
 - what are your views on the lessons that could be drawn from the approach to access pricing adopted for retail-only water competition in Scotland and for common carriage of water in New South Wales, Australia, or from the approaches that are used for access pricing in other utility sectors in the UK?
4. What access pricing methodology would you recommend and why? What do you see as the key advantages and disadvantages of each of the alternatives?
5. What implications would each access pricing methodology have for cost reporting? Would any of the approaches require other changes either to the WSL regime or to how Ofwat regulates appointed water companies?

¹²[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/\\$FILE/competitionreview_070404.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/competitionreview_070404.pdf/$FILE/competitionreview_070404.pdf)

4.1.2 Eligibility threshold

Current position

In its July 2002 consultation¹³, the Government proposed an initial eligibility threshold of 50MI a year. This resulted in approximately 2,200 eligible customers who, together, consume approximately 530,000 MI a year, which represents about 13% of total water usage in England and Wales. The Government argued that this would allow the effects of the new framework to be evaluated in light of practical experience before any decisions were taken on further extension of the competitive sector. It also proposed that the Secretary of State (in England) and the Assembly (in Wales) should be able to alter the threshold through secondary rather than primary legislation, following consultation with Ofwat and other interested parties. This consultation also stated that the Government would consider the advice it received from Ofwat relating to a lower threshold at any time, and would publish an initial response within 90 days.

The 2002 consultation recognised that a lower threshold could lead to potential customer benefits from more competition. However, it stated that such benefits would need to be weighed against:

- the potential for increased risks to the environment;
- effects on water resource planning;
- effects on water quality;
- any additional regulatory complexity; and
- any potential increase in financing costs.

Initially, Defra planned to review the eligibility threshold in 2008, but has committed to bringing this review forward.

We believe that the current eligibility threshold is likely to be a significant barrier to the development of effective competition in the water sector and further information on this is set out in our Outcomes paper. However, a reduction in the threshold is unlikely to be sufficient by itself to enable the development of competition to progress sufficiently. We consider that changes to the Costs Principle are likely to be needed as well and others have also expressed the view that a lower threshold may stimulate competition but that higher potential margins for licensees are also needed.

We also consider that the lack of certainty about the reduction of the threshold is unhelpful for new entrants seeking to plan and build a competitive water business. In other sectors, the market has been opened up progressively in tranches, but there has been clarity that the market would be fully opened to competition in time, allowing new entrants to build business plans on the basis of the ability to reach more customers over time.

¹³ Defra, 'Extending opportunities for competition in the water industry in England and Wales', July 2002.

The findings from the research into business customers' views on competition in the water industry provide details of customer views on eligibility in the WSL regime. Five per cent of respondents identified a range of practical problems and barriers, including the high eligibility threshold.

Other countries and utility industries

In Scotland, all non-household water and sewerage customers are eligible to switch supplier regardless of their size. There is no threshold restriction on those who can change supplier. The volume threshold would need to be reduced to zero (making all non-household customers eligible) to bring eligibility in England and Wales into line with Scotland.

Water industry competition reforms in New South Wales, Australia, aim to offer households and businesses more choices, including in the provision of recycling services. Licences can be granted by the Minister to provide network operator or retail supply services to both small and large customers throughout New South Wales. The application of the access regime parts of the Act is initially limited to water and wastewater infrastructure in the greater Sydney and Hunter regions only, with its geographic scope to be subject to future review.

Competition in the electricity and gas markets in the UK was phased in over an eight-year period, due to the large number of customers and the technical complexities involved. In April 1990 the first tranche of the electricity market, covering about 5,000 large customers with a maximum demand of 1MW and above, was opened to competition. Ten years later 81% of customers in this market were supplied by a non-local supplier. In 1991 British Gas also opened their market to competition with the first tranche affecting three-quarters of non-domestic customers that had a consumption in excess of 25,000 therms a year. The second tranche of the gas market was opened between 1992 and 1995, dependent on location and affected customers with a consumption of between 2,500 therms and 25,000 therms per annum. In April 1994 the second tranche of the electricity market, covering about 50,000 medium-size customers with a maximum demand of 100kW-1MW, was opened to competition. This market competition has also developed well and now more than 50% of customers are supplied by a non-local supplier.

The last and the largest tranche of the electricity market covering about 26 million customers with a yearly consumption of up to 12,000kWh, so called 'designated customers', including domestic and small business customers, was progressively opened up for competition between September 1998 and May 1999. In May 1998 the domestic gas market, approximately 18 million customers, was fully opened to competition. By the start of 2001 about 11 million (38%) of domestic customers had switched supplier at least once. About 100,000 electricity customers are switching supplier each week, of these 56,000 in net terms are choosing to leave their former regional supplier.

The initial market opening in electricity in 1990 covered around 5,000 large customers which is more than double those eligible under the WSL regime. In 10

years of operation 81% of those customers had switched, while after 20 months of the WSL regime no customer has switched.

Options

We have carried out an initial analysis of the effect that a lower threshold might have on the size of the competitive market, the average percentage margin per customer available to entrants, and the ability of new entrants to exploit scale economies in retailing. From collating consumption data provided by four water undertakers on non-households, split by UK Standard Industrial Classification of Economic Activity (UK SIC (92)), we were also able to assess the different types of customer premises that would be eligible to be supplied at different thresholds.

Our analysis has indicated that a reduction in the threshold to 20MI/yr would mean that customers predominantly in manufacturing, hotels and restaurants and education would become eligible. Dropping the threshold to 5MI/yr would make further customers eligible, including tobacconists, newsagents, chemists, restaurants and hairdressers. At a threshold of 1MI/yr customers in recreational and cultural sectors, such as libraries, museums and sporting venues would become eligible.

Table 1 presents estimates of the size of the competitive market at different eligibility thresholds on a cumulative basis. These estimates are based on data that eighteen water undertakers provided for 2005-06.

Table 1 Estimates of market size at different thresholds

Annual consumption threshold (MI)	Number of customers	Total consumption (MI per year)	Undertakers' revenue (£m per year)
>50	2,200	530,000	280
>20	5,700	605,000	370
>10	11,900	669,000	440
>5	27,600	749,000	540
>1	162,200	951,000	780
>0	1,245,500	1,105,000	1,000

These estimates show that a lower threshold would significantly increase the number of customers who are eligible to switch supplier, with more than 1.2 million customers becoming eligible if the threshold were reduced to zero. The effect is less pronounced in terms of consumption volumes and water undertakers' revenues, given that the additional eligible customers would be increasingly smaller in size.

We also examined what effects different thresholds might have on the extent of avoidable costs, these costs as a proportion of total retail costs, and their relationship to customers' total bills. While further analysis will be helpful, we set out

initial results here. This analysis looks at margins available to licensees as a percentage of the customer's bill.

Not all customers cost the same to supply; for example, large customers may have many separate points of supply on site that are billed separately, and they are likely to receive more frequent bills than smaller customers. Also, water undertakers typically provide account management services only for their largest customers and not for other customers. These account management services (in particular the use of key account managers to support the customer-water undertaker relationship) comprise an important part of total avoidable costs.

It is also the case that retail costs are not entirely volume-related; for example, while larger customers may receive more bills, the retail cost of each bill is fixed and not related to how much water is supplied.

Therefore, for larger customers, retail costs are a smaller proportion of the total costs of supply than for small customers. But there are also likely to be more avoidable costs incurred in supplying large users than in supplying smaller customers (on a per customer basis).

We carried out some illustrative modelling to explore the effects of different thresholds on these issues. We found that a small reduction in the threshold would widen the market to include medium size customers. These are customers who do not attract key account management services (and therefore the level of avoidable costs per customer are smaller), and for whom retail costs in total are a higher but still fairly small proportion of the total costs of supply. A slightly lower threshold therefore would mean the average amount of avoidable cost per customer is lower, but the average proportion of retail costs to total costs per customer is higher. So the amount of available margin per customer could actually be smaller than at a higher threshold (although of course there are more customers from which to earn a margin, and this analysis does not take account of economies of scale).

But a larger reduction in the threshold would widen the market to include many more customers, many of whom will be small customers. The level of avoidable costs per customer is not much lower than for medium size customers but these smallest customers have the highest proportion of retail costs to total costs of supply (because the fixed costs are a much bigger proportion of the smaller total bill). Hence avoidable costs as a proportion of the bill are higher. So the combined effect is that a very low threshold can increase the average percentage margin per customer.

These differences in percentage margin would not necessarily have any effect on the feasibility of new entry, because they simply reflect differences in the cost of retailing to customers of different sizes (expressed as a proportion of the total bill). New entrants are also likely to be affected by these cost differences, and so any increase or decrease in the margin available to entrants is likely to be coupled with a corresponding change in the licensee's own cost base.

A lower threshold could help to stimulate competition by giving new entrants greater scope for exploiting scale economies. In other words, it would potentially allow new entrants to spread their fixed costs over a larger customer base.

However, on its own a lower threshold is unlikely to be sufficient to allow competition to flourish, because it would not address the problems caused by the Costs Principle. These problems, discussed in our Outcomes paper and in this paper, mean that an entrant with the same unit costs as the incumbent will be competing at a disadvantage because of the access price it has to pay to the incumbent.

A lower threshold would also have implications for some of the other issues discussed elsewhere in this document. In particular:

- a low threshold would probably require a move away from customer-specific access prices, at least for smaller customers, to avoid the transaction costs associated with calculating individual access prices for each customer;
- lowering the threshold could raise further issues in relation to eligibility and the definition of “premises”. For example, would we need to reconsider the definition of “premises” to include mixed-use premises where there is a household located over a non-household business, such as a newsagents. This could be further complicated if the household and non-household parts shared a water meter; and
- the customer transfer protocol has been developed and tested to work if the eligibility threshold were lowered slightly. However, if the threshold were reduced significantly, such as to 0MI/yr to allow all non-household customers to switch supplier, this would increase the number of eligible customers to approximately 1.2 million, increase the number of transfers dramatically, and likely to require a different system (such as a centralised market authority, regional or company-specific market authorities) to cope with the extra volume of transactions. At a minimum, there would need to be an automated system in each appointed area where data on eligible premises are kept and switching is managed.

In the light of our review of these issues and considering the further implications of reducing the threshold, Ofwat recommends an eligibility threshold reduction. The level of the threshold is still under consideration and will require further analysis. However, we consider that a single reduction to a low threshold will have a more beneficial effect than a stepped reduction over a period of time. Notwithstanding this, should a stepped reduction be preferred this could be managed as long as there were to be a clear commitment to and timescale for the threshold reduction to enable new entrants to build their businesses.

A signal that there would be such a reduction would enable the industry and Ofwat to begin to address the issue of central switching systems and enable new entrants to start planning business cases around the certainty that more customers could be reached in due course.

Summary

- We welcome the Government commitment to bring forward a review of the threshold and we recommend that the threshold be reduced, in parallel with a review of the Costs Principle and other aspects of the competition regime.
- We consider that a significant one-off reduction in the threshold would be more beneficial than a stepped approach, which could further delay market opening.

Consultation questions

6. Do you support Ofwat's view that the threshold should be reduced? If not please explain why.
7. To what level (if any) should the threshold be reduced and why?
8. If you do support a reduction in the threshold, should it be a single or stepped change? Why?
9. Over what timescale do you think the threshold should be reduced? Why?
10. What changes do you think would be needed elsewhere in the WSL regime to make competition work with a lower threshold?

4.1.3 Definition of premises

Current position

WIA91 does not define 'premises' and does not give any guidance as to the extent of 'premises' (although section 17C does set out for the purposes of WSL the meaning of 'household premises'). In November 2005, Ofwat issued guidance under section 17A(9) WIA91 on the factors to be taken into account in determining the extent of any premises for the purposes of the eligibility requirements. That guidance was approved by the Secretary of State, following consultation with the Assembly. We believe the intention of the WSL regime is to capture the idea of a single water customer at a single set of premises. In order to do this, the extent of a customer's premises should be assessed by reference to the buildings, other similar structures and/or areas of land for the benefit of which water is being, or will be, supplied.

There will be a single set of premises in the following circumstances:

- (i) the premises are located within a single boundary and a single customer occupies the premises and is liable for water bills in respect of those premises (single boundary premises);
- (ii) the premises consist of co-located buildings, other similar structures and/or land which have adjoining boundaries or which are separated only by transport infrastructure and a single customer occupies the

premises and is liable for water bills in respect of those premises (common occupation co-located premises); or

- (iii) the premises consist of a single building or co-located, separately occupied buildings, other similar structures and/or land with all four of the following characteristics:
- they have a common landlord or managing agent in respect of the totality of the premises;
 - they have adjoining boundaries or are separated only by transport infrastructure;
 - they are served by a self-contained common water supply system that does not belong to a water undertaker (section 66D(1) WIA91); and
 - a single customer is liable for water bills in respect of the totality of the premises (common management co-located premises).

Our definition of a single set of premises for the purposes of our eligibility guidance follows case law and is consistent with how water undertakers treat their large users for charging purposes. We have, however, been asked to expand our view of “premises” to include separate sites with the same ownership (e.g. every branch of the same high street shop), as this would increase the number of eligible customers. The Government was clear in its July 2002 consultation paper that it was not in favour of ‘multi-site’ aggregation. Because there is no specific prohibition on this in the WIA91, we could revise our eligibility guidance to include multiple sites, but this would require the approval of the Secretary of State under section 17B(2) WIA91.

Other countries and utility industries

In Scotland, retail competition for water and sewerage services will apply to all non-household customers regardless of their sector, location or size from 1 April 2008. Eligible premises are defined in section 27(1) of the Water Services etc. (Scotland) Act 2005 (WSA05) as those that are connected or are to be connected to the public water supply system or the public sewerage system and are not dwellings. Under section 27(2) WSA05, ‘dwellings’ are defined by reference to the definition given for council tax purposes in the Local Government Finance Act 1992 (i.e. premises in respect of which council tax is payable.) This ensures that licensees cannot make arrangements to provide water and sewerage services to households. However, premises which are technically residential but which form part of a building whose main purpose is as a business, such as a care home, and are not caught by the definition of dwelling, will fall within the definition of eligible premises. They will be able to receive water and sewerage services from a licensee even though for council tax purposes parts of the building may be classed as a dwelling. Under section 27(3) WSA05, Scottish Ministers have the power to amend the definition of a dwelling for the purposes of the Act.

A gas customer in the Britain is defined as any premises supplied directly from a licensed gas transportation network, where metering equipment is used for the purpose of calculating charges for gas consumption. An electricity customer in

Britain is any energised or de-energised entry or exit point to the licensed electricity distribution system, where metering equipment is used for the purpose of calculating charges for electricity consumption. Competition is open to all electricity and gas customers, regardless of location and size, domestic and non-domestic and hence the definition of premises is not relevant.

Options

We do not propose to recommend any changes to the existing definition of premises in our eligibility guidance. However, we will keep our guidance under review. In our experience the three definitions of a single set of premises are appropriate and we have received no examples of premises that do not fall within one of the three types.

We do not intend to change the definition of a single set of premises to allow for multi-site aggregation. This is mainly because a reduction in the threshold would remove the need to aggregate different sites and would do so with less regulatory and administrative burden. A lower threshold automatically includes some premises that previously would have had to have been aggregated in order to qualify. However, if it became evident that the threshold was not going to be reduced (at all or by very much, or that it would take a long time to implement) then we may revisit the aggregation issue and consider different approach.

Summary

- We do not consider that a change is required in the current guidance on the extent of an eligible premises.
- We do not propose to recommend multi-site aggregation at this stage.
- We would revisit these proposals if there were no change to the eligibility threshold.

Consultation questions

11. Do you agree with Ofwat's proposal not to change the current guidance on the extent of premises? Please give reasons for your response.
12. Do you agree with Ofwat's proposal not to consider multi-site aggregation at this time? Please give reasons for your response.

4.1.4 Contractual aggregation (in-area trading)

Current position

A licensee that is related to a water undertaker (an “associated licensee”) is not at present permitted to carry out relevant activities in the statutory area of the water undertaker to which it is related. Relevant activities include those authorised by an undertakers' licence (such as supplying water to customers' premises) but not, for example, operating a call centre. This limitation is imposed by a standard condition of water supply licences and by legislation. This means that associated licensees

are unable to aggregate contracts with individually eligible customers on a national basis as they would be unable to serve customers located in the area of the water undertaker it is associated with. Independent licensees may trade nationally and therefore are able to aggregate individually eligible customers on a national basis.

Other countries and utility industries

Scottish Water will remain the only wholesale service provider in Scotland, and therefore it will become the wholesaler of water and sewerage to its own retail business (SWBS) and to any new entrants. SWBS will clearly operate in the same geographical area as Scottish Water, but it will not be “competing” with it. Rather, it will, on the same footing as other licensees, buy retail services from Scottish Water – subject to any ordinary licence conditions imposed by the Commission to ensure orderly market development. The WICS intends to ensure that Scottish Water operates within a clearly defined “ring fence” so that SWBS receives no unfair advantage over any other retailer.

Options

Contractual aggregation is different from multi-site aggregation as only eligible premises would be able to be aggregated.

An advantage of allowing associated licensees to aggregate contracts on a national basis (i.e. trade in the area of the water undertaker it is associated with) would be that the associated licensees could bid for national contracts for eligible customers, thus increasing customer choice and potential margins for licensees. It would put associated licensees on a level footing with independent licensees. It would also mean, however, that independent licensees would be competing against both the incumbent’s notional retail arm and the associated licensee. It would also mean the associated licensee would be competing against that incumbent’s notional retail arm, which it does not do at present due to the limits on where an associate licensee can trade.

If Ofwat were to consider allowing associated licensees to trade in the area of the associated water undertaker, it would be essential to enforce regulatory requirements for arm's length trading.

Summary

- We consider that allowing contractual aggregation (in-area trading) for associated licensees would facilitate effective national competition.
- Such a move would require regulatory oversight to avoid either the actual or perceived abuse of the relationship between the incumbent and the associated licensee.
- Implementation of contractual aggregation (in-area trading) could require a change in primary legislation, which we could pursue in a recommendation to Defra.

Consultation questions

13. Do you believe that in-area trading should be allowed? If not, please explain why and propose an alternative approach.
14. If you consider that in-area trading should be allowed, what regulatory controls do you think would be necessary to safeguard the development of competition and protect consumers?

4.1.5 Licence application fees

Current position

At present, we charge applicants for processing applications for a water supply licence¹⁴. The amounts that we charge are set out in the Water Supply Licence (Application) Regulations 2005¹⁵.

We charge each licensee the cost of processing its licence application to avoid customers paying for the costs of specific new entrants (through Ofwat's recovery of its costs from undertakers).

The fees that we charge for processing licence applications are broadly cost reflective. These costs would be minimal on a per customer basis when recovered through Ofwat's usual mechanism of recovering its costs, yet they represent a barrier to entry for individual licensees if they are obliged to bear the whole cost.

Other countries and utility industries

In Scotland, section 9 WSA05 allows the WICS to make a fees scheme for the purpose of funding the ongoing operation of its licensing functions. The current fees scheme relates only to Scottish Water Business Scheme ("SWBS"). We understand that the existing scheme will be replaced by a new one, providing a basis of charging for persons other than SWBS. The new scheme will be cost-reflective, with application fees recovering the costs of assessing licence applications (currently estimated at £4,750 per application) and an annual levy to recover the costs of monitoring and enforcement which will be capped at a total of £1.2 million a year. The annual levy will be payable only from 1 April 2008.

The New South Wales, Australia *Water Industry Competition Act 2006* allows the Minister to impose specified charges on licensees to recover the real costs of administering the licence. The charges may be an upfront sum, or periodic payments, or a combination of both.

Licence application fees in the gas and electricity industries were last revised in 2004. Ofgem has consulted on new fees which will take effect from mid July. The fees are set to take account of Ofgem's staff time and overheads. Applicants cannot

¹⁴ £2,500 for a combined licence, £2,000 for a retail licence, £1,350 for variation of a retail licence to add the supplementary authorisation and £550 for a variation of a combined licence to remove the supplementary authorisation.

¹⁵ SI 2005 No. 1638.

make joint applications for electricity and gas licences. The proposed new application fees for domestic and non-domestic electricity and gas supply licences are £450. Electricity generation is £500, electricity transmission is £500 and electricity distribution is £1400. Gas transporter licence is £1050; gas shipper licence is £350. Interconnectors are £10,150.

Options

We are considering whether to seek an amendment to the secondary legislation to remove licence application fees payable to us for processing licence applications until such time as the overall access pricing regime is amended. Changing the amount payable would also require a change in the secondary legislation.

The current approach is not in line with the current access pricing regime which in effect requires the new entrant (and thus the customers of the new entrant) to pay for the avoidable retailing costs of the incumbent, e.g., for the incumbent's billing costs, even where the new entrants' customers are not receiving billing services from the incumbent. Furthermore, undertakers did not pay an application fee for their appointment at privatisation¹⁶ and potential inset appointees do not pay an inset appointment application fee. The proposed change would therefore bring licence applications in line with other policy.

We also consider that the fee is a barrier to entry for potential licensees, because although the amount is small it contributes to the overall high cost of entry into the WSL market when set against current likely margins, especially in the retail market.

We are considering the recovery of licence application costs via the normal mechanism of annual fees, rather than a specific fee payable by the licensee, in order to reduce entry barriers for new entrants in the short term. Once access pricing issues are resolved, however, and larger numbers of new entrants began applying for licences then specific application fees could be reintroduced.

Summary

- We are considering removing the licence application fee payable to Ofwat by an applicant for a water supply licence, and instead recovering the costs by the normal annual fee mechanism.
- Any change to the current system of application fees would require an amendment in secondary legislation, which we could pursue in a recommendation to Defra.

¹⁶ Condition N required the payment of an initial payment from each water undertaker once an appointment was granted but this was not an "Application fee".

Consultation questions

15. Do you agree with the removal of specific licence application fees and the recovery of the relevant costs via the normal mechanism instead? If not, please explain why and propose an alternative approach.

4.1.6 Supplier of last resort

Current position

Stakeholders have expressed some concerns in relation to their perceived level of security of supply. Discussions at our industry advisory groups have indicated that there is a lack of understanding among customers about their current security of supply and that this should be addressed by providing clearer information to customers rather than changing legislation. But some customers have expressed concerns that there is no statutory duty on a water undertaker to be a 'supplier of last resort' (SoLR) in the event of their licensed water supplier going out of business or withdrawing from the market. It appears that some customers are not confident that the interim supply duty and the strategic supply designation process, which are explained below, would give them the security of supply they seek when deciding whether or not to change their supplier.

The findings from the research into business customers' views on competition in the water industry provide details of customer concerns about the security of their supply. Forty per cent of respondents highlighted that a guarantee to switch back to their existing water supplier and receive their current service provision, would make them more likely to consider changing supplier. When asked what could be done to develop further the competitive market, 18% of respondents selected imposing a duty on existing suppliers to take back customers at their original service level.

This section sets out the mechanisms already in place under WIA91 to provide customers with a supply of water in the event of a licensee failing to supply. It also explains the non-statutory 'stand-by' service that water undertakers can offer to licensees or customers (for which they can charge).

Under WIA91, water undertakers are not obliged to guarantee supplies for **non-domestic** purposes. Specific agreement (and payment of a premium) can guarantee security of such a supply. Despite this, it appears that customers generally consider that in the absence of a SoLR, 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 WIA91), 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 water undertaker 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 water undertakers' 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.

Under section 56 WIA91 Ofwat has powers to determine requests for a non-domestic supply under section 55 WIA91.

In the case of combined supplies, difficulties can arise in the provision of supplies of last resort. For example, if a water undertaker deferred a capital scheme because a large customer switched to a licensee, the water undertaker 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 the combined licensee were to fail. Sections 66G and 66H WIA91 allow us to determine whether one or more introductions of water into a water undertakers' 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 water undertaker 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 a water undertaker asks us to, or where we decide to do so.

If an introduction is designated 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 water undertakers' supply system.

When considering whether an introduction should be designated as strategic, sections 66G(10) and 66H(10) WIA91 allow us only to consider the domestic and non-domestic needs of the water undertakers' 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. There is general agreement that this needs to be addressed and we propose to recommend to Government that this is an issue that can be remedied alongside the other proposals set out in this paper.

Other countries and utility industries

The WSA05 requires Scottish Water legally to separate its retail function for non-household customers. Scottish Water has no retailer of last resort duties. Where arrangements between a licensed provider and occupier of eligible premises terminate, Scottish Water's duty to supply water ceases. However, under section 17(1) WSA05, Scottish Water must maintain physical supplies for two months. During this time either the customer will find a new supplier (worst case on the

“default” tariff) or the Central Market Agency¹⁷ will re-allocate the supply points that were registered to that licensed provider. Licensed providers will be obliged under their licence to act as retailer to all supply points allocated to them. Effectively, therefore, Scottish Water must retain sufficient supplies to meet the needs of all customers of all retail licensees at all times.

In New South Wales, the *Water Industry Competition Act 2006* provides for the appointment of retailers of last resort and requires each to develop a contingency plan setting out the arrangements that are in place to ensure that it can meet its obligations as a retailer of last resort. It is envisaged that the appointed retailers of last resort will be the incumbent suppliers given their universal coverage. Amendments have been made to the *Hunter Water Act 1991* and the *Sydney Water Act 1994* to facilitate this.

Ofgem can direct any gas or electricity supplier to take over responsibility for customers of a failed supplier. In considering which supplier to direct, Ofgem must be satisfied that the SoLR could supply the additional customers without significantly prejudicing its ability to supply its own customers and to fulfil its contractual obligations for the supply of electricity or gas. This is similar to the “interim duty to supply” in the case of water where the duty is not absolute. Ofgem would always prefer to appoint a SoLR that had consented to the role. However if there is no other suitable supplier Ofgem will consider using its powers to direct a supplier without its consent.

Ofgem requires potential SoLRs to provide information on the following issues.

- The ability of the supplier to carry out the role without significantly prejudicing its ability to supply its own customers.
- How the SoLR will manage the change of supplier process, so as to minimise disruption to the failed supplier’s customers.
- The provision of information to customers and dealing with enquiries.
- Each suppliers deemed last resort contract price and allowance for termination of the contract, should the customer wish to switch to an alternative supplier.

Ofgem would prefer to appoint one SoLR for all of the failed supplier’s electricity customers and one for its gas customers, due to system constraints and providing clarity to customers. There may be circumstances, however, where the portfolio has to be split. For example in gas, the portfolio can be split between domestic and non-domestic customers.

Options

We do not propose to seek a change to the current legislation associated with the SoLR duty. This is because we consider that the legislation as it stands effectively

¹⁷ The CMA (funded under the 2006-10 Strategic Review of Charges) will be established as a company limited by guarantee without shareholders. It will be responsible for 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.

mirrors a SoLR regime, similar to that in the gas and electricity markets, as discussed above. Also, as set out in WSL 03/07 'Water supply licensing (WSL) – Best practice' (2 May 2007), we believe that it is undesirable for water undertakers to refuse to supply a customer who wishes to return to the water undertaker after having switched to receive a retail supply from a licensee under section 66A WIA91. We also believe water undertakers should give a measure of comfort to customers who may switch away to licensees for retail supplies, to assure those customers that they would be able to switch back to them easily. In order to achieve this, we propose to ask water undertakers to publish their SoLR obligations and duties which they will make available to all customers that switch under the WSL regime, including the default tariff and service level that would be provided to such returning customers, whether that was the customers' original service level or an alternative.

The strategic supplies designation process should give comfort to customers receiving a combined supply.

There are also other provisions in legislation, for example under the Competition Act 1998, that may in certain circumstances require an incumbent not to refuse to supply a customer.

In addition to these proposals, we consider that there is a lack of understanding among customers about their current entitlement and security of supply. The lack of a formal SoLR duty has been raised. However, in our work with stakeholders it has generally been agreed that a change in legislation is not needed, but that clarity of the current regime would be extremely helpful. We will work with the industry to inform customers further of their entitlement should any licensee be unable to continue supply its customers.

Summary

- We consider that the legislation as it stands effectively mirrors a formal SoLR duty and therefore we do not propose to recommend changes to Government.
- However, we propose to ask water undertakers to make their SoLR obligations public to add transparency for customers.
- We do not propose to make or seek any significant changes to the current SoLR duties; however, we will work with the industry to inform customers of their rights in connection with SoLR.

Consultation questions

16. Do you agree that the current regime effectively provides the equivalent assurances as a SoLR regime, and that as a result, changes are not needed to the present SoLR regime? Please give reasons for your response.

17. Do you agree with the proposal that water undertakers make their SoLR duties and obligations public, including the terms and conditions they would offer returning customers? Please give reasons for your response.

18. Do you agree that improved communication and publication of additional information about customers' rights will ease current concerns?

4.1.7 Competition in providing sewerage services

Current position

At present, most customers receive sewerage services from the incumbent sewerage undertaker. There is a range of options for the on-site treatment of trade effluent and a market in the provision of these services already exists.

The Government consulted on competition in sewerage services in its 2000 consultation paper, 'Competition in the Water Industry in England and Wales' and respondents to that consultation expressed no interest. The Government's 2002 consultation stated that competition in sewerage would be excluded from WA03 because there is already a significant level of competition in sewage and effluent treatment. In addition, the Government considered that to extend competition to sewerage services would require a complex and costly regime. However five years since that consultation, we consider that it is appropriate to explore the desirability of a new framework that might complement and support the development of competition in the related market of water.

We believe it would be useful to explore the desirability of creating a particular legal framework to promote such a market.

Other countries and utility industries

Scottish Water's wholesale activities do not involve interaction with the end customer. The operational aspects of sewerage services include the collection and treatment of wastewater and trade effluent and all the cleaning processes so that it can safely be returned to the environment. Under the competition framework in Scotland, licensed entrants will be able to deliver retail sewerage services to non-household customers. Retail activities include all matters relating to:

- retail pricing and tariffs;
- billing and collection of charges;
- debt follow up and debt management;
- meter reading and customer meter operations;
- call and correspondence handling;
- responses to customer enquiries, complaints or requests for information;
- key account management;
- liaison with the wholesaler to deal with customer issues; and
- marketing.

The New South Wales, Australia *Water Industry Competition Act 2006* includes:

- a third party access regime (common carriage) for sewerage services;
- a licensing framework for the supply of water and services to all customers (i.e. residential, commercial and industrial etc); and
- a framework for the arbitration of disputes by IPART associated with sewer mining (extraction of sewage for recycling).

In addition, the process of establishing a sewer mining operation, negotiating connections to, and extractions from, the wastewater system have been streamlined through new procedures and the development of standard contracts. In addition, amendments have been made to the *Environmental Planning and Assessment Regulation 2000* to make it easier to gain approval for small water recycling plants that discharge to sewers rather than the environment by removing the need to prepare a Environmental Impact Statement in such cases. Together these reforms make it easier to produce and supply recycled water for businesses and householders.

In the gas and electricity industry in the UK, suppliers and customers recognise the value of dual fuel supplies. In 2005, 67% of gas customers received gas and electricity from the same supplier. Supplying dual-fuel reduces transaction costs for fuel suppliers, since they send combined bills for gas and electricity, receive one payment and can combine debt recovery and customer service procedures. These savings are then passed on to the customers through discounts for dual-fuel tariffs. Ofgem's 'Domestic Retail Market Report (DRMR) 2005' found that most switchers change to a dual-fuel package. Customers perceive this as being more convenient and are attracted by the potential savings.

The dual billing of water and sewerage supply could save costs. This could be beneficial if introduced in the water and sewerage industry as customers perceive dual billing as more convenient.

Options

In our experience to date, customers and licensees seem to support the introduction of competition in providing sewerage services. While there is no specific framework for sewerage competition in WIA91, it is not prohibited. However, licensees consider that because of the absence of a specific framework they would gain no benefit, in the way that they would under the WSL regime from agreeing an access regime with an undertaker (for example by water undertakers deferring capital sewerage schemes). One licensee wanted competition not only in on-site treatment but also in wholesale format. Some potential inset appointees have raised the issue of competition in providing sewerage services, as part of inset appointments but there appears to have been no substantial discussion.

In general, we consider that retail competition in sewerage would be a welcome addition to the WSL regime. A parallel "combined supply" sewerage supply regime, however, would raise many issues. Combined supply competition for sewerage is not a mirror image of combined water supply competition. For example, licensees

would have their own source of water to displace an incumbent's source, but in sewerage the source remains that which the customer discharges.

Retail sewerage competition could add benefits to the existing WSL regime, for example the issue of only one water and sewerage bill by the licensee.

There is already a competitive market for the treatment of trade effluent at source. The provision of on-site treatment solutions is a widely contestable market and does not require changes to continue.

Summary

- The inclusion of sewerage in the WSL regime would require changes in legislation, which we could pursue in a recommendation to Defra.
- We consider that retail sewerage could be a viable option and should be included as part of the WSL regime.

Consultation questions

19. Do you consider that retail competition in sewerage should be included as part of the WSL regime? Please give reasons for your response.

20. Do you think combined competition for the provision of sewerage services is possible and/or desirable? Please give reasons for your response.

4.2 Inset appointments

Current position

We continue to receive significant interest in inset appointments. We have accepted a proposal from Scottish and Southern Energy Water (SSE Water) to provide water and sewerage services to a new housing development near Salisbury. If granted SSE Water will be the first new water and sewerage undertaker since privatisation and the first new appointee to serve household customers, and the second new entrant overall (Albion Water obtained its appointment in 1999, and currently supplies water to one large non-household user).

We plan to consult on our amended inset appointment guidance in November 2007. This section sets out some of the proposed changes to gather feedback from stakeholders prior to the guidance consultation.

There are three types of inset appointment available under current legislation.

- **Large user**
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 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.

- **Unserved site**

An area which is not served by an incumbent appointed company is known as an unserved site. This includes an area that may be currently supplied by unregulated or private supplies with its own source of water. This applies to water supplies for a water inset appointment application and to sewerage services for a sewerage inset appointment application.

- **Incumbent consent**

This type of inset appointment is where the incumbent appointed company consents to transfer a particular area to the inset appointee.

Ofwat has duties (section 2(2A) WIA91):

- (i) to ensure efficient undertakers can finance and properly carry out their functions; and
- (ii) to protect the interests of consumers, wherever appropriate by promoting effective competition.

In the case of inset appointments, the appointee is not being given a licence to compete, but rather is being appointed as a monopoly water undertaker. The customers of that new appointee therefore may have no choice as to who supplies them with their services. Consequently, the application process is rigorous because of the need to protect customers where a new exclusive right is being granted. We must be satisfied that any proposal is operationally, technically and financially viable, as well as showing how consumers will be protected. Some potential new entrants have said that they have found it difficult to meet our requirements during the application process. Some have argued that our process is too slow and too burdensome on small, new businesses.

We accept that we should examine our application process to see if we can streamline it. Some of the options were outlined in the Outcomes paper and are repeated below. In RD1206 (4 August 2006)¹⁸, we asked Regulatory Directors what changes they would like to see the amended inset guidance cover. Respondents stated that the main problems with the current inset application process were:

- the level of information requirements;
- the timescale;
- the lack of consideration of multi-utility projects; and
- ongoing price regulation for small inset appointees.

¹⁸ <http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/rd1206>

We welcome suggestions as to how inset appointments can be developed through innovation. Experience in other sectors has shown that innovation flourishes in a competitive environment where businesses innovate to keep costs down and to retain or obtain customers. As part of the review of our inset guidance we welcome further input as to how innovation can be fostered in the interests of consumers.

We also want to examine whether inset appointments are generating enough benefits for consumers, particularly those household customers on new developments. Most recent interest in inset appointments has been for the provision of services to household customers on unserved sites. But an agreement is often struck between the potential appointee (who is in competition with the incumbent and/or other potential appointees) and the landowner/developer. Customers are not involved in an appreciable way in that process, and must accept whomever the developer chooses as the monopoly supplier of services (as long as Ofwat grants the appointment).

In theory there may be competition in the process by which the developer chooses its preferred partner, but there is not much evidence to suggest that much competition exists between potential appointees for the same developments. Furthermore, if the competition is managed by the developer there is no customer voice in the process. We want to encourage more competition in this part of the process. The options for doing so are set out below.

Other countries and utility industries

In New South Wales, Australia, an inset appointment has been established at the Sydney Olympic Park Authority to supply recycled water to homes and local facilities. The Sydney Olympic Park Authority provides a complete system for water management within its discrete area, encompassing storm water harvesting, improving storm water quality for irrigation needs, water treatment infrastructure, water supply infrastructure and sewage treatment.

In the gas industry in the UK, the majority of new companies are Independent Gas Transporters (IGTs), which develop, operate and maintain local gas transportation networks. Competition is most established in the new-build housing market.

Electricity distribution networks are monopolies, because there is only one owner/operator in each area. Domestic and commercial customers buy their electricity from suppliers. Independent Distribution Network Operators (IDNO) own and operate electricity distribution networks which will predominately be network extensions connected to the existing distribution network, for example to serve new housing developments.

Options

We are considering the following options for when we revise our inset guidance:

- Securing parent company guarantees to cover the inset applicant in the event of financial difficulties, which may alleviate concerns we might have when assessing the ongoing financial 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.
- Developing policy to consider the recovery of infrastructure charges.
- Clearer guidance on the setting of bulk supply prices and terms.
- Separate inset guidance for incumbent appointed water companies
- Including up-to-date case studies in the revised guidance.

Some options for change in the level of competition for unserved sites include the following.

- Publish details of any inset proposal brought to us for an unserved site, to attract other potential appointees who can then compete for the appointment.
- Require developers to demonstrate to us their selection process and criteria for choosing their preferred partner.
- Require potential appointees to demonstrate what benefits they will bring to end consumers on the site.

Summary

- Changes can be made to the inset regime without changes to legislation.
- We consider that the application process should be reviewed and that the options set out above would be an improvement.
- We will consult on amended inset appointment guidance in November 2007.

Consultation questions

21. Do you think that the options set about above for changes to the inset guidance are sufficient?
22. Prior to the issue of the inset appointment guidance consultation are there any other issues that Ofwat should cover in its guidance?

5. Options for longer term change to the water and sewerage industry

Chapter four concentrated on changes to the existing competition regime, some of which can be done without changes in legislation and some of which require Government support and new legislation to implement. All of these options are based on the work done so far leading to the development of the WSL regime and on the assumption that the regime should be used as the basis for further development of competition.

This chapter considers some alternative approaches to promoting competition in the water and sewerage sectors. While some of these were referred to in the Government's 2002 consultation, 'Extending opportunities for competition in the water industry in England and Wales', it seems appropriate, in light of the lack of progress to date, to revisit these, and other options. You are invited to give your views on these options and to suggest additional or alternative models for consideration as part of our review of the markets.

5.1 Cost allocation

No matter what model is used to promote competition in the water and sewerage sectors, at this stage existing incumbent water undertakers will play a pivotal role. It is likely that for the foreseeable future they will continue to provide services directly to non-contestable end customers as well as many contestable customers and at the same time will provide services to competitors so that the competitors, in turn, can provide services to end customers.

We believe it is essential to understand better the costs incurred by incumbent operators in providing services to customers, competitors and customer groups. This serves a number of useful purposes.

- Tariffs that are cost based are generally considered to be fair with those using the services paying for the costs incurred in providing the services.
- Transparent cost allocation allows customers to see what costs are involved in the services they are using, and properly unbundled cost allocation and service choice allows customers to pick and chose only those elements of the service they wish to use and to know what they are paying for each element.
- If costs are transparently allocated, then it is clear what costs the incumbent incurs when it supplies its own notional "downstream" retail arm with services which in turn enables that retail arm to sell services to end customers. Competitors can see and buy the same services at the same prices and have confidence that the incumbent is not discriminating between its own notional downstream arm and competitors. This provides a level playing field for the development of competing service offerings.
- Competitors can choose those elements of service from the incumbent that they need in order to "build" their own service to end customers, and clearly see and understand the costs they will incur to do so.

- Competitors can separately cost those elements of the service that they provide to end users, providing the opportunity for competitors to provide the services in a more efficient way.

These are just some of the reasons why we consider a more transparent cost allocation mechanism may be appropriate in the water sector and we are currently developing a work stream to address this issue. Because this transparency in cost allocation will underpin many of Ofwat's key strategies, it is not directly dependent on our work on competition but it is clearly linked. As set out in our Forward Programme we will publish further proposals on this area in the near future and this work will progress in tandem with the review and other relevant work streams. However as set out in chapter one we ask for stakeholder's responses to the issues set out in this paper to allow us to progress our work on the review of market competition.

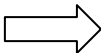
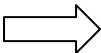
5.2 Unbundling of services

As described in chapter two, the water and sewerage sector in England and Wales comprises a number of potential markets. The overall value chain in the sector includes the following stages.

Water

Collection/abstraction  Treatment  Distribution  Supply

Wastewater

Collection  Treatment  Disposal/Discharge

For effective competition to develop in these sectors, we consider that it will be important to understand where the costs and values lie in this value chain. This level of transparency will help to demonstrate where markets are contestable and where they are not. This in turn will allow an appropriate allocation of costs to relevant parts of the value chain and thus make those elements more accessible to competitors on an equal footing to incumbent operators. We will be carrying on some additional work in this area and in the following sections we set out some ways in which the cost information and the unbundling of those costs can be used to help to promote competition in the sector. As set out in chapter one, although the work in other areas such as unbundling is ongoing we ask for stakeholders' responses to the issues set out in this paper to allow us to progress our work on the review of market competition.

5.3 Accounting separation

Accounting separation involves identifying a business' discrete activities and functions and treating each of these as if it were a separate business unit. Each unit

“trades” with others, but there is no legal or structural separation of the business units: they are merely accounted for separately. This section will explore accounting separation of retail functions from other functions, although it could be extended to cover the whole of the value chain. The cost allocation project that Ofwat set out in its ‘Forward Programme 2007-08 to 2009-10’ will look to identify cost drivers accurately. This would underpin any move towards accounting separation, which, if carried out effectively and properly reported, can improve transparency of costs and may reveal redundant services and costs. Potential entrants to markets are able to see the costs incurred in particular activities and functions rather than aggregated at company level. Appropriate identification of activities and cost drivers, together with suitable cost allocation processes are central to achieving meaningful accounting separation.

With appropriate cost allocation information providing the transparency as to where those costs lie, there is potential in considering whether the incumbent operators should be required to separate their accounts, thus clearly reporting this information along an agreed split of the business.

One example of this would be where the activities, costs and revenues of notional retail arms could be separated out and the obligation on incumbents not to discriminate between their own notional retail arm and WSL licensees more effectively scrutinised and enforced.

Other options could be to separate out the accounts of the “network business” that supplies common carriage services to licensees and their own notional retail suppliers.

Accounting separation is common in other utility sectors (electricity, gas, and telecommunications) and has proven very effective in facilitating the development of competition. The separation of accounts could be achieved by changing the reporting requirements on companies as set out in licence condition F and/or the Regulatory Accounting Guidelines and would not require primary legislation.

Current position

We currently collect some data in companies’ June returns that disaggregates costs, but there is no formal accounting separation of activities. The principal disaggregation for water services analyses operating and capital maintenance costs in two categories: water treatment and resources/distribution. For the sewerage service, the analysis is done between sewerage, sewerage treatment and sludge treatment and disposal. Customer services (which includes retail costs), scientific services and other business activities are not allocated to specific activities.

Other countries and utility industries

In Scotland, the Commission has updated its regulatory accounting rules to ensure that retail and wholesale services are separated. Scottish Water Business Stream is required to submit separate regulatory accounting information to Scottish Water.

Telecommunications

The unbundling of BT's network infrastructure elements was achieved by separating BT's infrastructure business from its Sales and Marketing business. This wholesale and retail split was delivered through accounting separation.

In 1999 the Secretary of State agreed that, similarly, BT could take 100% ownership of BTCellnet subject to the extension of accounting separation and allied provisions to cover its mobile activities.

Gas

In 1993, a report to the Monopolies and Mergers Commission recommended a full corporate split-up of British Gas into a monopoly network company and a trading company as well as a requirement to further reduce market share in the industrial sector to no more than 40% for very large users and 55% for medium users. The Government broadly agreed these recommendations. However, while it did not require separate ownership for network and commercial activities, it did enforce via the regulator and a compliance unit with British Gas internal separation to such an extent that there was no commercial incentive to keep the two businesses under common ownership. Government also required that retail competition be extended to all users in a process taking two years and starting in 1996. In 1996, British Gas took a commercial decision to make the split complete separating the trading division into a separate company. It was decided to make a split between trading and network activities in 1996. In 1997 the company was split into Centrica, the company that sells gas to final consumers, and the much larger BG plc which owned the network, up-stream gas activities and all activities outside the UK.

Electricity

In the UK, the Regional Electricity Companies (RECs) owned the distribution networks and retail supply businesses. Accounting separation was imposed upon them in 1997. However, concerns that companies would cross-subsidise their competitive retail businesses from their monopoly distribution businesses eventually led to full physical separation.

Options

We could require companies to allocate and report separately on all activities and costs linked with providing retail services to customers, and the costs incurred between their notional wholesale and retail businesses in supplying customers. We could also ask companies to separate the costs of production (abstraction and treatment) from bulk and local distribution. Accounting separation could be effected with a change to water undertakers' appointment conditions and changes to our RAGs.

Summary

- Accounting separation could be achieved without change to current legislation.
- Accounting separation has proved beneficial in other network utilities and we consider that could also be the case for the water and sewerage industry.

Questions for consultation

23. Do you agree that accounting separation could bring benefits in terms of transparency and could facilitate more effective competition? Please explain your answer.

24. What functions or activities do you consider should be accounted for separately and why?

5.4 Structural separation

Current position

The Government stated in its July 2002 consultation that undertakers should remain vertically integrated to maintain a necessary level of control over the supply of water, maintenance of the quality of water and protection of the environment.

Some stakeholders have suggested that vertical unbundling of different parts of the value chain would mean that the natural monopoly element in water distribution/transport would be clearly separated and regulated, as it is in many other utilities. The pipeline operator would then have no incentive to exclude entrants and indeed would have an incentive to generate new business.

Legally separating businesses means that costs have to be allocated to specific activities and reduces the degree of allocation and apportionment of costs that is needed if activities are accounted for separately but under the same legal activity. More rigorous separation, as in other utilities, would create more transparency in cost allocation and possibly reduce costs by identifying and eliminating unnecessary activities. Some stakeholders have commented that production is closely linked to distribution (treatment and pumping are interlinked activities) and cannot be easily separated in operational terms. Also, separation could generate more costs (transaction costs between activities, new set up costs) and lose the valuable economies of scope of a vertically integrated company.

Other countries and utility industries

Water

In Scotland, legal separation is central to the regime. Scottish Water is required by law to establish a separate undertaking (known as Scottish Water Business Stream) to deliver the retail elements of water and sewerage service provision to non-household customers. Scottish Water Business Stream must apply to the Commission for a licence if it wishes to offer these retail services. The Commission has set a requirement on Scottish Water Business Stream that if it wishes a permanent licence for retail services it must demonstrate a full and proper separation from Scottish Water. From April 2008 licensed entrants will be able to compete to supply retail water and sewerage services to non-household customers.

In New South Wales, structural separation has not been required under the *Water Industry Competition Act*, consistent with a 2004 recommendation by IPART. That said, owners of infrastructure subject to a third party access declaration are required to maintain separate accounting arrangements for those elements of its business.

Gas

At privatisation, the gas industry was split into 12 regional vertically integrated structures. During 1989-90 the company separated into three business units (Gas Business Britain, Exploration and Production, Global Gas) and by 1991 the 12 regions had been re-organised into 91 districts across Britain. In 1994, in response to recommendations from the Monopolies and Mergers Commission, British Gas underwent further restructuring to separate its trading operations from its transportation activities. The UK gas business was separated into five separate business units.

- Transco – transportation and storage.
- Public gas supply – domestic market.
- Business Gas.
- Service.
- Retail.

In 1997, British Gas demerged its trading businesses into two separate companies, Centrica plc and BG plc. This reflected the need for greater focus within particular areas of the gas business.

Electricity

Before privatisation, the electricity industry in England and Wales consisted of the Electricity Generating Board (CEGB), responsible for generation and submission, and 12 regional area boards, responsible for distribution. During privatisation, the industry was restructured, separating transmission from generation. The CEGB was separated into three generating companies and the national grid. These companies and the 12 distribution boards were privatised and a wholesale market was created (the Electricity Pool). The separation of generation from transmission and distribution aimed to increase competitive pressure on generation and therefore reduce costs.

Telecommunications

With the passing of the Telecommunications Act 1984 the business of British Telecom the statutory corporation, transferred to British Telecommunications plc and Government sold 51% of its shares. In December 1991 the Government sold around half its remaining shares, reducing its stake to 21.8%, with the remaining shares sold in a third flotation in July 1993.

The 1984 Act abolished British Telecom's exclusive running of the telecommunications systems and established a framework for competition. British Telecom was required to be licensed in the same way as any other telecommunications operator.

In December 2000, following modifications to BT's licence, BT offered local loop unbundling (LLU) to other telecommunications operators, enabling them to use BT's copper local loops (the connection between the customer's premises and the exchange) to connect directly with their customers. In November 2001, BT Wireless – BT's mobile business mmO2, was demerged from BT.

Under the Communications Act, 2003, the licensing regime was replaced by a general authorisation for companies to provide telecommunications services subject to general conditions of entitlement and, in some instances, specific conditions. Under a specific condition BT retained its universal service obligation (USO) for the UK, excluding the Hull area. The USO included connecting consumers to the fixed telephone network, schemes for consumers with special social needs, and the provision of call box services.

Following the Telecommunications Strategic Review, in September 2005 BT signed legally-binding Undertakings with Ofcom to help create a better regulatory framework for BT and the UK telecoms industry generally. A result of this was the establishment of Openreach by BT in January 2006 in accordance with the undertakings given to Ofcom under the Enterprise Act 2005. Openreach manages the UK's telecommunications infrastructure, and delivers services to any and all communication providers including BT's own downstream business which it must treat on an equal basis as other operators. Openreach is one of four businesses which make up BT Group. The other three are BT Retail, BT Wholesale and BT Global Services, which all focus on their own markets and customers.

Options

Structural separation has produced benefits in many markets (e.g. BT Openreach and British Gas as set out above). We could consider various forms of structural separation; however complete structural separation would require significant changes to primary legislation. Such significant changes would require considerable further research as part of a longer term plan. Any such proposal would need commitment also from Government.

Summary

- Structural separation is an option for consideration but would require significant changes in primary legislation, which would also require the support of Government.
- We welcome view on the position we could take with regard to structural separation.

Questions for consultation

25. What do you consider would be the benefits and detriments of considering structural separation in water and sewerage services? Please give reasons to support your response.

5.5 Household competition

Current position

In its July 2002 consultation, the Government considered that the drawbacks of introducing household competition (uncertainty, unwinding of cross-subsidies, differential pricing and significant costs to customers) were not consistent with its objectives with regard to public health and social policy. It concluded that these drawbacks were likely to outweigh the potential benefits of household competition.

Little has changed since then, as discussion has focused on the development of the market for WSL competition.

Presently there is limited comment from householders on whether they wish to see competition in water supply and there is no research into customers' views. However, those customers cannot receive any of the direct benefits that the current WSL regime might deliver. Therefore it is necessary to maintain a regulatory regime, including the costs of that regime, to protect those customers from monopoly power.

A competitive market for household customers would require consumption to be properly measured, as for the gas and electricity industry. At the moment, only an average of 30% of customers are metered, although the concentration of metered customers varies from region to region, and more than 50% of customers are metered in some areas and fewer than 10% of customers are metered in others.

In the absence of a competitive market for the supply of water to household customers, those who are ineligible to be supplied under the WSL regime continue to rely on the regulatory system of comparative competition and price controls operated by Ofwat.

Other countries and utility industries

Household competition is not provided for in Scotland for water and sewerage services. The Scottish regime allows competition for all non-household customers only with non-household premises defined as premises other than domestic dwellings.

The competition reforms in New South Wales, Australia aim to offer households and businesses more choices, and encourage innovation, particularly in the supply of recycled water services.

In Great Britain households are able to choose their suppliers for gas and electricity. The gas industry was fully opened to domestic competition in 1998, following a pilot study in the south-west of England. Household competition in the electricity industry was phased in during 1998. Further details are set out in section 4.1.2.

Options

There have not been many views expressed on the possibility of household competition and this may be because there is a perception that exclusion of households from market competition is not up for debate. While we do not set out in this consultation document a specific view on household competition we are interested in the views of respondents on the possible benefits and drawbacks of such competition. In particular, we would be interested in views on whether household competition could become viable and beneficial in association with greater meter penetration.

Summary

- The implementation of household competition would require an amendment in primary legislation.
- The development of household competition could progress in parallel with greater meter penetration.
- We welcome views on the potential benefits of household competition.

Consultation questions

26. Do you consider that there are potential benefits to be gained from household competition?
27. Should household competition be considered in parallel with greater metering?

5.6 Competition in the “production” of water

Unlike gas and electricity, there is no “production” or “generation” market for water. Water is obtained in a number of ways, ranging from direct abstractions, collections in reservoirs, to such mechanisms as desalination plants. For an effective competitive market to develop properly, it is necessary to consider how competition could be introduced into this part of the value chain. One possibility could be to introduce an easier method for trading abstraction licences and this is discussed further in section 5.7. Other options include allowing access to incumbent owned water resources on a competitive basis, for example in the form of a “water release” programme similar to the “gas release” programmes run in the gas sector.

Current position

Distribution and treatment

Under WIA91, there are no barriers to constructing or operating treatment and distribution works such as pumping stations, water treatment works, desalination plants and sewage treatment works. However, there are a number of factors which make competition in this area problematic.

- The high costs of installing such infrastructure may be prohibitive for some operators. Traditionally, this type of infrastructure has been seen as investment that is only suitable for undertakers because, under the regulatory regime, they can incur relatively high costs to install the facilities and wait for a length of time to recover the costs.
- In addition, water undertakers need to maintain their standards for supplying water, such as pressure and quality. This means that, for efficiency purposes, it may be preferable for them to maintain operational control of such installations.

However, there are a number of factors which have improved the opportunities for competition in this area, including:

- the arrival of new technologies, such as small package sewage treatment works that can treat the sewage from small scale housing developments; and
- changing demand requirements; such as an increased demand for water systems that are managed in an environmentally sustainable way.

Such systems are already operating outside the regulated business. For the purposes of this paper, therefore, we need to consider ways of incorporating these arrangements into the regulated treatment and distribution system.

In the current market, the water that is produced by such systems is treated very much as a by-product, rather than having a financial value. For example, small package sewage treatment works are installed primarily to reduce the costs of sewage treatment to the properties that they serve. Any water that is produced is generally discharged back into local water courses. Operators have to obtain, and

pay for, a discharge consent from the Environment Agency before they can do this. There is no financial recognition of the value of treating and or distributing the effluent as a recycled water resource, even though, in some cases, the effluent may be treated to a level that would be suitable for direct input into the water undertakers' own treatment works.

In addition to this, under the WSL regime, any operators of treatment or distribution works are unable to put water into the incumbent's supply system until they have customers that they wish to supply. However, they are not prohibited from selling their water to the undertaker, although the likely small scale may not make it attractive or economic for the undertaker to buy the water.

Releasing water resources

In addition to considering ways of allowing new entrants to input water into incumbents' systems, we should also consider the possibilities for releasing resources, in a controlled way, for the purposes of improving competitive opportunities. In the gas industry, as set out below, release programmes are seen as an effective way of reducing the incumbent's dominance of the market and increasing opportunities for new entrants. They generally occur in unbundled markets where long-term contractual constraints have restricted access to competitive wholesale gas markets.

Other countries and industries

Gas

The UK Government introduced a variety of measures to release gas to new entrants, resulting in the successful development of competition between gas suppliers and significantly lower prices on the wholesale market. These lower prices were fed through to end-consumers as they became eligible to choose their gas supplier.

- 90/10 rule – this was a voluntary undertaking by British Gas to only contract for 90% of the volume from new fields, leaving 10% to be bought as a supply contract by another company. The undertaking was met, but was less effective than hoped, partly because of the lead-time in bringing new fields into production, but more because the 10% contracts were secured up for gas-fired power generation rather than competitive supply for smaller customers.
- Time swaps – British Gas plc sold gas back to the producer in exchange for purchasing the gas under the same terms and conditions at an agreed time in the future, such as five years' time. Despite full compliance from British Gas, this was only partly successful because it maintained the net long-term gas-purchasing position of the incumbent and the gas was not directly available to new-entrants.
- Gas Release Programme 1992 to 1995 – In March 1992 British Gas plc gave an undertaking to the Office of Fair Trading to release gas from its long-term contracts to speed access to gas supplies by independent traders. This was part of a set of undertakings by British Gas to secure the development of genuine self-sustaining competition for eligible customers. The gas release programme was administered by the regulator Ofgas.

Options

Distribution and treatment

In the short term, the industry could develop a voluntary framework that would enable operators of private treatment works to input their water directly into the incumbent water undertakers' treatment works or pre-treatment distribution systems, at cost and in accordance with the undertakers' terms and conditions. This may also help the undertaker to reduce its own costs and may increase its general water management efficiency.

In the long term, if required, we could consider a more formal, structured system for these arrangements to take place; this could include the introduction of a water release programme using similar principles as those in gas set out above.

Releasing water resources

Water undertakers could be asked to release allocations of their supplies within the water industry in England and Wales. This could take the form of either a formal release of their abstraction rights or their distribution rights as set out in each water undertaker's conditions of appointment. Such measures could be supported by a re-allocation of customers. Either of these options would require new primary legislation.

Summary

- Limited competition in the provision of treatment systems (for example building onsite treatment facilities for grey water) already takes place outside the regulated water services.
- There are some barriers to introducing competition in this area into the regulated system but these may be overcome.
- A water release programme could be beneficial to competition in the production of water.

Consultation Questions

28. Do you agree with our assessment of the opportunities for competition in this area?
29. Do you consider there are any other factors that we need to take account of?
30. Do you have any other suggestions for developing competition in this area?

5.7 Competition in abstraction

Current position

The Environment Agency's role is primarily to protect the environment and to manage water resources for the benefit of society and the economy. It has contributed significant resources to improving the framework for trading water rights in recent years.

Under the current abstraction licensing regime, anyone who wants to abstract more than 20 cubic metres of water per day from a surface source (e.g. river, stream or canal) or from an underground source needs a licence from the Environment Agency. The Environment Agency assesses every application for potential impacts on the environment and other abstractors and decides whether or not to grant a licence. When considering licence applications, it has to have regard to its aims and legal duties to protect both existing licensed abstractors and the environment. As part of this process, it may advertise the application and consider responses from members of the public who may be affected by the proposals.

There are approximately 21,000 licence holders across England and Wales who are currently regulated. A further 23,000 smaller use licences were recently deregulated. Restrictions might be placed on licences depending on specific local conditions.

There are other issues that need to be considered when assessing competition in this area.

Time limiting for abstraction licences

Under the Water Act 2003 (WA03), all new abstraction licences have to be time-limited. Some Environment Agency regional offices followed voluntary time-limiting policies prior to the implementation of the WA03. Time-limited licences carry a presumption of renewal but abstractors will need to re-apply for their licence before it expires. When they do so, they will have to satisfy the Environment Agency that they still need the water and have been using it efficiently. In addition, the Environment Agency will consider whether the abstraction has an unacceptable impact on the environment. The overall current position is that the majority of existing abstraction licences are permanent and have no time limit.

Interaction between WSL and abstraction licence trading

When a potential or actual water supply licensee applies to abstract water for the purposes of supplying its future water customers, it does not have to prove that the customers are already using the water or that the water will be used. The Environment Agency has put in place a mechanism that allows it to manage situations where the abstractor's need for water does not come to fruition.

The Environment Agency can apply to revoke or vary a licence at any time, although the licence holder must be notified and may object to this. If the holder objects, the proposal is then determined by the Secretary of State by way of a hearing or enquiry. Compensation may be payable to the licence holder depending on the period of use

or non-use of water prior to receiving notice of a proposal to revoke or vary the licence.

Trading in water rights

Abstractors and potential abstractors can trade existing rights in three main ways:

- An abstractor can give up all or part of their licence at a site for a set period of time, allowing another party to take up the 'slack' at that site; or
- An abstractor can permanently reduce the amount that they take from a site, allowing another party to increase abstraction at another site in the same catchment; or
- An abstractor can sell a quantity of the abstracted water to another party.

There is also the possibility to conduct simpler trades, for example where a licensed abstractor sells a licence to abstract from a specific point to another party. The ownership and responsibility for that licence would be transferred between parties. There are also short term trades which are particularly relevant in the agricultural sector. Further examples of how trading can occur are set out in the Environment Agencies leaflet 'Access water resources – a guide to water rights trading'¹⁹

Where the trade involves a variation of the amount that is abstracted, the Environment Agency assesses whether it is acceptable and applies the same tests that it would apply when assessing new licences. The Environment Agency currently estimates that there have been approximately 100 trades in the past five years.

Since 2001, the Environment Agency has published a Catchment Abstraction Management Strategy Process in order to promote a system of strategies (CAMS) for the sustainable management of abstraction at a local level. CAMS help resource developers to identify situations where a licence trade may be the best or only way to achieve their objectives.

In general, the Environment Agency has contributed significant resources to improving the framework for trading water rights in recent years, including removing the need to specify the land in which the water will be used, thus enabling the opportunities for the third type of trade listed above.

Other countries and utility industries

Water – New South Wales, Australia

New South Wales has worked to establish effective systems for water trading. In 2004-05 more than 1600 temporary trades took place amounting to 290,000 ML in New South Wales. Most trades currently remain within the state and are between existing licensed users. The rules governing the transfer of water in New South Wales require organisations to seek approval before trading can take place. Trading can only occur where there is a physical, hydrological link between the valleys and

¹⁹ http://www.environment-agency.gov.uk/commondata/acrobat/wrt_leaflet_1767496.pdf

where a Water Sharing Plan is in place. A Water Sharing Plan establishes rules for how water is allocated for the next ten years between the environmental needs of the river or aquifer and water users, and also between different types of water users such as town supply, rural domestic supply, stock watering, industry and irrigation.

In the past, various states and territories issued more entitlements to water than can be delivered by the water systems. The New South Wales government has taken action to address the problem of over allocation of water entitlements. In 2000, the water management framework was revised so that water management plans now specify access rights as a share of the water available. The New South Wales government has also begun a programme to buy back water entitlements, in order to improve river health and the security of water entitlements. Irrigators now own their share of the water available for consumptive use, which means they benefit from the scarcity value of water. The trading price of water will increase in a drought and fall in times of abundance, promoting efficient use of water during scarce periods.

The first step in creating a market for intra-state water rights was to define them as a form of property separate from real property. Licences are fully transferable, either permanently or temporarily, although trade may be restricted by statutory environmental considerations.

Options

The Water Act 2003 was a key instrument for revising the abstraction licensing processes. As such, many processes have already been reviewed and there appears to be little that can be done in the short term to improve these systems further. However, we consider that there are a number of issues where we can engage in dialogue with the Environment Agency about the future of competition in this area, these are set out below.

Procedure for reviewing the terms of abstraction

Where a trade involves a variation of the terms and conditions of the licence, the Environment Agency has to review the licence. It may be possible to reduce the burden created by this procedure which could reduce the length of time taken to achieve certain trades and the uncertainty around them.

Another alternative could be to review what constitutes a 'justifiable need' for the abstracted water. If the use of water for trading was allowed as a justifiable need for an abstraction licence, this might open up the abstraction licensing market. In this way, when their licence comes up for review, abstraction licensees who no longer need to abstract the water for themselves could be allowed to keep an abstraction licence for the purposes of trading their 'spare' water.

Procedure for improving information over the water rights trading

There is some crossover between the information about water resources that is available from the Environment Agency and the information that water supply licensees need to help them to consider whether to enter into combined supply or secondary supply arrangements. We could consider ways of disseminating information and making it easier for new water supply licensees, potential licensees or their customers to assess what resources are available and how this may help

them enter into a competitive market. In particular, we could consider producing a dedicated web-page including links to relevant pages explaining water resources and maps of the basic resource situation around the country.

Procedure for reducing uncertainty over future licence changes

There is uncertainty arising from the Habitats Directive and the Water Framework Directive. The outcome of these initiatives may be that the Environment Agency will make changes to the terms and conditions of existing licences in the future.

Consequently, abstractors are likely to hold onto any 'spare' unabstracted volumes as a form of insurance. They will want to reduce the potential need to buy additional licensed volumes if the water becomes scarcer and more expensive after any sustainability reductions have been implemented.

In addition to the above, we will consider, in conjunction with the Environment Agency, whether it is appropriate to devise a long term strategy encompassing both competition and water resource issues, to consider what further improvements, if needed, can be made to the existing regime.

Summary

- We will work with the Environment Agency to publish clear and up to date information about abstraction and water rights trading
- We are currently reviewing the interaction between competition and water resources.
- We are also talking to the Environment Agency about possible changes to the water rights trading regime.

Consultation questions

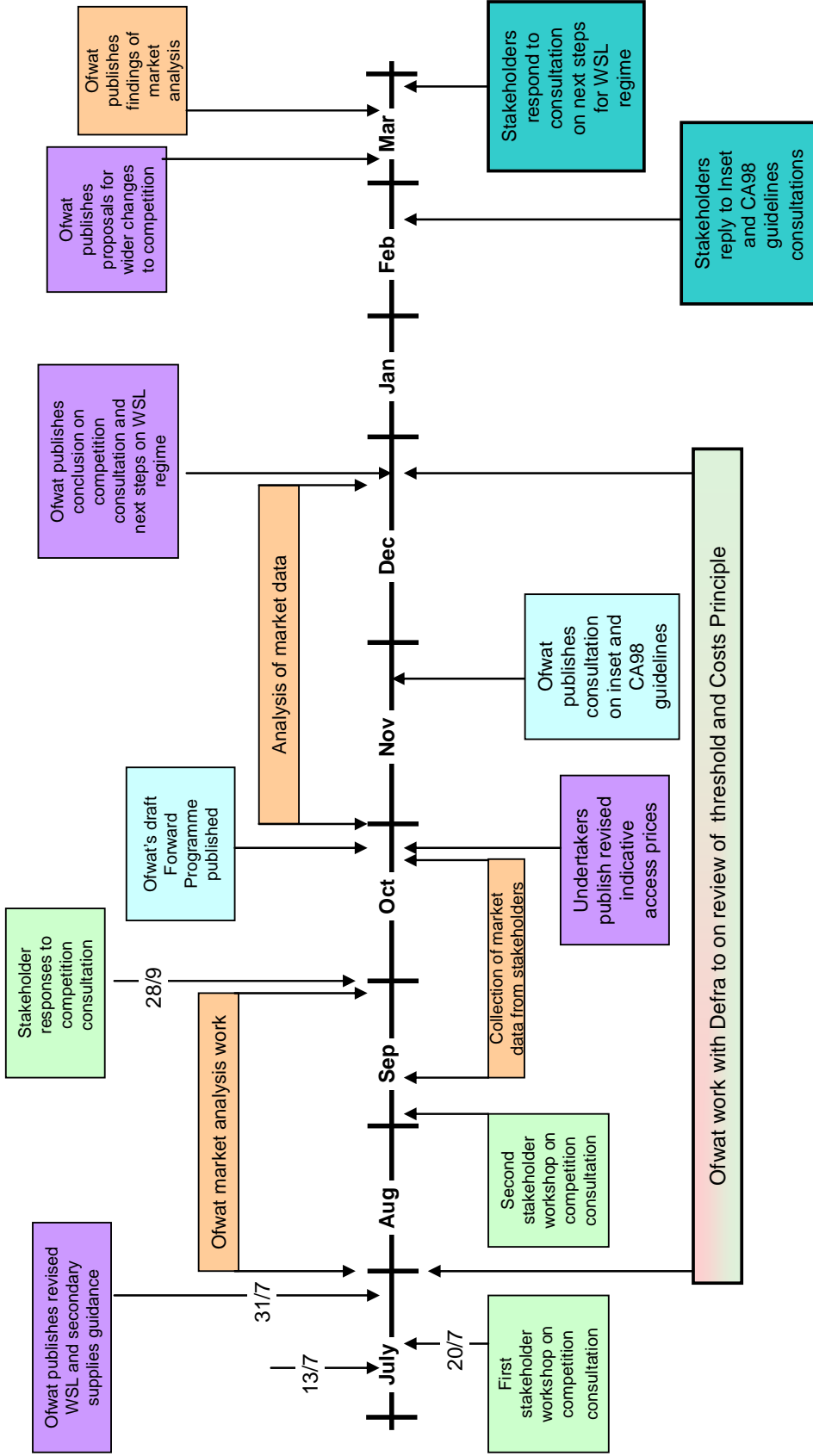
31. Do you agree with our assessment of the water rights trading regime? Please give reasons for your response.
32. Please consider how we can increase awareness of the abstraction trading regime?
33. Please consider how we could further facilitate water rights trading? Do you agree with our proposals for changing this? What other suggestions would you make?
34. Are there any other strategies that Ofwat could pursue to assist with the facilitation of combined supplies under the WSL regime?
35. What other steps could Ofwat take to increase competition in abstraction?

6. Next steps

The table below sets out the key milestones in the review and market analysis project going forward.

Timeline	Activity
20 July	Hold public discussion forum to discuss responses to this paper.
Late July	Publish updated WSL guidance and secondary supplies guidance and responses documents.
July to September	Internal analysis of markets for market analysis project.
September to October	Information requests to key stakeholders and interested parties.
Late November	Consult on proposed changes to the inset appointment guidance and the CA98 guidance.
December	Publish conclusions on competition consultation and next steps on WSL regime.
Spring 2008	Consult on wider changes to competition in the water and sewerage industries and publish the findings of our market analysis project.

Timeline for review of competition





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