

# **Market competition in the water and sewerage industries in England and Wales**

## **Part one : Water Supply Licensing**

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## Executive summary

The purpose of this paper is to present our recommendations for changes to the Water Supply Licensing (WSL) regime, as part of our plan to introduce effective market competition into the water and sewerage sectors in England and Wales.

On 13 July 2007 we published our 'consultation on market competition in the water and sewerage industries in England and Wales' (the 'July paper'). The July paper raised for debate a range of options to further competition and initiated a wider review of competition in the water and wastewater sectors.

This paper represents the conclusion of the first part of our competition review, which has focused on making the WSL regime more effective. It also includes our proposed way forward on accounting separation. This paper will be followed in spring 2008, by a paper which will draw on the second part of the review, looking at wider changes to the industry.

Many of our proposals met with widespread agreement from respondents to the July paper. Most respondents were in favour of the proposed changes to the WSL regime although a few respondents still question the appropriateness of competition in water and sewerage services. Most respondents agreed that the current Costs Principle has inhibited the development of effective competition, at least for the provision of retail supplies. They also agreed it would be more appropriate if Ofwat was required to specify how access prices should be set, with reference to general criteria set out in legislation to guide the regulator. Most respondents also considered that a reduction in the threshold to include all non-household premises would be appropriate.

Annex one sets out a detailed summary of the responses received to the July paper, and our comments on the responses.

Chapter three of this paper sets out our recommendations for changes to the WSL regime (collated in the box on page 4). Many of the proposed changes will require changes in legislation, with the exception of clarification of the existing supplier of last resort regime, changes to our guidance on premises and our proposals on accounting separation.

Our key recommendations are:

- To remove the Costs Principle from legislation and replace it with a set of general criteria for access pricing; and
- To reduce the threshold initially to a level of 5MI, to be followed as soon as possible by a removing the threshold to include all non-household customers.

As set out in the July paper, in the second part of our competition review we are undertaking wider examination of competition in the water industry, looking beyond some of the assumptions of the WSL model, for example, that of maintaining vertically-integrated monopolies and household competition. The paper in the spring

will consult on the emerging conclusions. As part of this wider work, we have ongoing work streams looking at cost allocation, value chain analysis and market analysis.

The results of our wider review may impact on the manner in which some of the recommendations in this paper are implemented. For example, different degrees of structural separation of the vertical monopolies could impact on the way that access prices operate.

The recommendations in this paper are intended to make the current WSL regime work better. These recommendations represent incremental improvements to the existing regime, rather than a return to the ‘first principles’ of competition. The introduction of the WSL regime itself was addressed in the extensive consultation on the Government’s proposals for competition in July 2002 and debate on the Water Bill 2003 (and its impact assessment) and the subsequent implementation of the Water Act 2003. The reduction in the threshold (i.e. the increase in the size of the contestable market) is likely to incur some costs, however because the initial step to 5MI would use current infrastructure, the costs are likely to be relatively small. The step to zero would require additional systems to handle switching and will have an associated cost. We will include the potential costs of this switching infrastructure in an impact assessment of proposals in the second part of the competition review.

## Summary of recommendations in this paper

### Recommendations for Ofwat to take forward:

- We will require undertakers to develop and publish a default SoLR tariff for all returning retail customers.
- We will ask undertakers to develop and publish SoLR tariffs for returning combined supply customers, to be approved as part of the charges scheme.
- We will publish an information note clarifying water undertakers' current SoLR duties and obligations under the WIA91.
- We will consult on and develop our proposals for accounting separation to be implemented by incumbent monopoly water companies.
- We will analyse and develop further possibilities for the provision of sewerage services in addition to those that can be provided on a retail basis.

### Recommendations that will require a change in legislation:

- The removal of the Costs Principle from the statute.
- Replacing the Costs Principle with a set of general criteria for access pricing and requiring Ofwat to decide the specific method(s) for access pricing having regard to these criteria.
- The eligibility threshold should be reduced to zero, but with an interim step to allow all involved to develop appropriate processes, and with a clear commitment to a zero threshold at a firm point in the future.
- The interim step reduction in the threshold to be set at 5MI.
- The initial step reduction to take place within a year and the reduction to zero within two years of that.
- That in-area trading is permitted as soon as possible.
- Government should pursue the changes to the strategic supply regime to allow further SoLR protection for combined licensees and their customers.
- That Government should allow retail competition for sewerage as part of the WSL regime as soon as possible.

### Other recommendations

- No changes should be made to the current licence fee arrangements.
- That the current legislation on supplier of last resort (SoLR) does not need to be changed for retail supplies.
- There should be no changes to the definition of premises at this time, but we will keep the definition of premises under review.

## 1. Introduction

We consider that effective competition in water and sewerage services will lead to greater consumer benefits in the future. Competition has delivered substantial benefits in other utility sectors, leading to lower bills, improved service, and choice for customers, and has enabled the gradual withdrawal of regulation where markets have become effectively competitive. Strengthening competition is also a key driver of dynamic efficiency and innovation; such innovation in the water sector will be crucial to enable it to meet the increasing challenges of the future, such as adapting to climate change and weather volatility, population growth, renewing ageing infrastructure and meeting increasing environmental standards.

The regulatory framework used by Ofwat in the water sector in England and Wales is based on comparisons between vertically integrated monopoly firms. This comparative competition has delivered significant benefits for users over the past 18 years. It has accommodated a very large programme of capital investment, improved the quality of service for customers significantly and provided incentives for efficiency improvements worth more than £100 per year in bill reductions for the average customer. England and Wales score reasonably well in international comparisons of water and sewerage quality and efficiency<sup>1</sup>.

However it has become progressively clearer that regulation of vertically integrated monopolies by means of comparative competition alone is not sufficient to deliver the best possible prices, incentives for innovation, quality and choice of services for users in the long run. Not only is the regime likely to be subject to diminishing returns over time, but in addition, for comparative competition to work effectively, it needs a broadly static industry structure with a statutory referral of all significant mergers to the Competition Commission.

Competition can help address these challenges and contribute to the delivery of the Government's objectives for the water industry as a whole<sup>2</sup>. For example competition could:

- stimulate a more dynamic retail sector, providing better services to customers and helping to reduce water wastage;
- provide a greater focus by water companies on improving efficiency and reducing costs of supply (including leakage), making water more affordable;
- encourage more efficient allocation of water resources, reducing the potential impact of the water industry on the environment;
- drive more innovation and dynamism in technology and processes, encouraging companies to find more efficient ways to abstract, treat and supply water, to help to address the impact of climate change, reduce the carbon footprint of the industry and improve the quality of the environment.

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<sup>1</sup> International comparison of water and sewerage service 2007 report, Ofwat, April 2007  
[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/int\\_comparison2007.pdf/\\$FILE/int\\_comparison2007.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/int_comparison2007.pdf/$FILE/int_comparison2007.pdf).

<sup>2</sup> See 'Extending opportunities for competition in the water industry in England and Wales', Defra/Welsh Assembly Government 2002.

In working towards the development of a competitive marketplace it is important to ensure that there is appropriate protection of public health and that, over time, the benefits of competition are captured for consumers. In addition, the regulatory burden can be lightened by regulatory withdrawal wherever possible.

We are continuing to work with the Department for Environment, Food and Rural Affairs (Defra) and the National Assembly for Wales (the Assembly). In the pre-Budget report published on 9 October 2007, the Government reiterated its commitment to a review of competition looking at all the necessary elements to ensure the regime delivers benefits for consumers and the wider economy. We welcome this. This paper and the forthcoming paper in spring 2008 are intended to contribute to the Government's review. In our opinion effective competition cannot be achieved without changes to legislation. Although, in addition, as set out in this paper, there are issues which Ofwat can take forward without changes to legislation.

## 2. Background

### 2.1 Progress in our review of competition

Since expressing our concerns about the development of competition in water supply licensing in MD215 ('Delays in the WSL regime' April 2006), we have looked in detail at why competition has not developed, and possible options to remedy the situation.

In the July paper we explained the reasons why we wish to develop effective market competition further. Primarily, we believe that competition will promote and protect the interests of consumers by delivering sustainable benefits in terms of choice, price and quality of services, as well as stimulating innovation. The development of effective competition could also lead to regulatory withdrawal, thus reducing the regulatory burden in the sector.

Since July we have made some progress in trying to improve the WSL regime. On 31 July 2007 we published our amended WSL guidance and new secondary supplies guidance. We also published a revised Appointment Condition R to strengthen water undertakers' obligations regarding confidentiality and we are currently working with the industry to develop compliance guidance to support those changes. These steps are to encourage new entrants into the WSL market and to allow competition to develop.

In addition, the indicative access prices published by water undertakers in October and November this year suggest that there may be greater potential for effective competition where new entrants are providing combined supplies. We are working with our industry groups to consider the scope to improve the identification and allocation of ARROW<sup>3</sup> costs under the Costs Principle to further improve this potential. The indicative access prices for retail supplies are still low. We are also developing information on supplier of last resort arrangements in the sector to provide more confidence to customers who might potentially switch supplier if they had a greater understanding of and clarity on this issue.

We will take these measures forward, as well as some other changes that do not require legislation to implement. However, we consider that legislative changes will be necessary in some areas if effective competition is to develop in the sector. All the changes we consider should be made to the current regime are set out in chapter three of this paper. We will say more in spring 2008 about legislative changes that may be needed to deliver wider reforms.

This paper is one of several related work streams we are carrying out which will help to promote effective competition. We are continuing with proposals to introduce greater transparency in costs, and our analysis of different parts of the value chain. The proposals in this paper, particularly for a larger market, more flexibility in setting access prices, and greater transparency of costs, will remain valid in relation to the

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<sup>3</sup> 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).

wider changes we outlined in July and which we will propose in more detail next spring.

We have also progressed our market analysis project which is intended to broadly identify the markets that exist within the water and sewerage sectors and, along with some analysis of the value chain, will help inform decisions about the contestability of those markets. We have gathered information directly from stakeholders and the outcome of the work will also be published in spring 2008.

## **2.2 Purpose and structure of this consultation**

The consultation is structured as follows.

- Chapter 2 provides an overview of the review of competition in context with other related work streams.
- Chapter 3 sets out a summary of the responses to the consultation on options for change to the current market competition regime, including our proposals going forward.
- Chapter 4 gives an update on the work towards more fundamental ideas for change, including responses to the July paper.
- Chapter 5 sets out an overview of the costs and benefits of competition.
- Chapter 6 sets out the next steps in our review of competition.
- Annex one includes a full responses document to the consultation questions in the July paper.
- Annex two sets out an overview of the indicative access prices received from water undertakers in 2007.

## **2.3 Responding to the consultation**

The recommendations covered in chapter three of this paper mainly confirm the proposals set out in the July paper, which received much positive support from respondents to that wide-ranging consultation. In the light of this support, and in the context of little progress in WSL competition so far, we want to press on with our proposals as quickly as possible. Therefore, we invite any further views on the recommendations in this paper by 8 February 2008.

This paper is only Part One of our approach to competition. Part Two will look at wider changes to the industry, and we aim to publish that in spring 2008. This paper also sets out some aspects of this wider work, and we welcome any further comments on the wider issues around competition by 10 March 2008.

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 respond in writing to Hayley Purcell at Ofwat. Electronic copies of your response may be sent to [hayley.purcell@ofwat.gsi.gov.uk](mailto: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.

We propose to publish responses to this consultation on the Ofwat website, unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, might be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory 'Code of Practice' with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your I.T. system will not, of itself, be regarded as binding on Ofwat.

### **3. Changing the current competition regime**

#### **3.1 Approach to access pricing**

Under current legislation, WSL access prices (whether agreed by the parties or determined by Ofwat under 66D WIA91) must be set in accordance with the "Costs Principle" (as defined in section 66E WIA91).

Our views on the Costs Principle are well-known. It requires the licensee to bear the undertaker's costs of competing with the licensee, and it limits the ability of entrants to undercut components of the incumbent's retail costs that are deemed 'unavoidable', even if they may be inefficient.

In addition, the Costs Principle is a 'one size fits all' access pricing methodology. It applies to combined supplies (where the licensee uses its own water), primary wholesale supplies (where the licensee buys water from the undertaker and competes only in the provision of retail services) and secondary wholesale supplies (a combination of buying water from one undertaker and using it to supply customers in another undertaker's area).

We believe different types of competition are likely to require different methods of pricing (see section 3.1.2). Many respondents supported this view, in their replies to the July paper. For example retail competition is not influenced as much by geographic factors, or by capital investment decisions, whereas combined supply is. But the Costs Principle does not provide enough flexibility to be able to address different markets in different ways.

And the Costs Principle mandates a negotiated access regime that relies on undertakers to provide cost-based discounts, when they are the ones who hold all the information about costs. While we can begin to address problems relating to information asymmetry and proper cost allocation through changes to appointment conditions requiring greater accounting separation, they would not address the root issues.

Consequently, we do not expect retail competition to flourish under the Costs Principle, although some customers may switch and greater cost transparency may allow more to do so. The same may not hold for combined supplies, where indicative access prices suggest that, in some locations, larger discounts may be available to entrants who provide new water resources to replace undertakers' planned resources. However, higher available margins for combined supplies are accompanied by higher entry costs (especially capital investment required to develop resources and treatment facilities) and we have seen little evidence to date that combined supply competition is actively being pursued. Annex two provides a short summary of the latest set of indicative access price discounts published by undertakers in October and November 2007.

We believe it is appropriate to develop an access pricing regime that better reflects the underlying cost of access and is better designed to facilitate new entry and promote the development of effective competition. 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 require Ofwat as the economic regulator of the sector to implement access pricing regimes that meet those criteria.

Sections 3.1.2 and 3.1.3 look at how we could specify access pricing methods in the future should the Government remove the Costs Principle from statute. In the interim we are still required to use the method set out in section 66E Water Act 2003.

### **3.1.1 Responses to the July paper**

Most respondents agreed that the current access pricing regime inhibits the development of effective retail competition; a large number of respondents felt that the current pricing approach should be retained for combined supplies, but that a different method may be appropriate for retail supplies.

A large proportion of respondents agreed, in principle, to the proposal that the criteria governing the access pricing regime should be set out in primary legislation and that we, as the economic regulator, should develop the detail within those criteria but with flexibility to decide which regime is best for particular markets. Most undertakers highlighted the need to protect ineligible customers when considering access pricing methods.

Full details of the responses are set out in annex one.

### **3.1.2 Retail and combined supply competition**

Within the current WSL regime, there are three different types of access arrangements:

- wholesale supply by a primary undertaker (Section 66A WIA91);
- combined supply by a licensee (Section 66B WIA91); and
- wholesale supply by a secondary undertaker (Section 66C WIA91)<sup>4</sup>.

These access arrangements, and their appropriate access price methods, are affected by different factors. This section looks at these different factors, and the different access price methods that may be appropriate.

- **Retail competition<sup>5</sup>**

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<sup>5</sup> For ease, we refer to 'retail competition' as the market in which licensees compete to provide retail services to end-customers. Technically, as set out in sections 66A and 66C, licensees require access to undertakers' wholesale services, in order to support their own retail activities. This new link in the supply chain – wholesale supplies – was introduced by the WSL provisions of the Water Act 2003, and only applies to functions and services provided by undertakers to licensees under WSL access. In many respects, undertakers' wholesale activities mirror their 'retail' activities directly to end-customers.

The main aspect of retail competition is that costs incurred by the wholesaler or the retailer are unlikely to vary significantly between different classes of customer, or between customers in different locations. Many of the costs are standard (the cost of producing a bill or reading a meter), or are not customer-specific (they are driven by staff time, for example in dealing with enquiries). The cost of producing a bill for £1,000 is largely the same as producing one for £100,000; similarly, the amount of time and level of skill required to handle an enquiry is not dependent on which customer has raised the enquiry. Of course, the number of meters read, bills produced or enquiries handled can vary between customers (large users are billed more frequently and often have more meters to read), but that is simply an issue of scale.

Furthermore, retail competition is unlikely to affect undertakers' decisions about network development and investment, or the costs of environmental improvements. All retailers will contribute to these costs via wholesale access charges.

Consequently, in order for retail competition to flourish, it is vital that every competing retailer is treated on an equal basis by the wholesaler and is able to access the same wholesale services on the same basis. If some retailers (for example the incumbent's notional or separated retail arm) have preferential access, for example because of vertical integration or historical privileges, then new entry is likely to be deterred and competition is unlikely to flourish.

An appropriate wholesale access pricing method will need to support equal treatment of retailers, and make use of the fact that many costs (and hence discounts from the end tariff) can be standardised. Therefore, we would support a method that used an averaging approach to costs, on a fully allocated basis. Averaging would occur on both a geographic basis, and customer-class basis; different customer classes may be more or less expensive to serve but within each class there should be an average wholesale price.

The activity of water retailing is comparable to retailing in other utility industries. Therefore there would not seem to be any reason that this market is not contestable in principle. For example, there is no fundamental difference between the activities of meter-reading and billing in the electricity and gas sectors and the activities of meter-reading and billing in the water sector which would make these activities inherently contestable in one sector but not in the other.

- **Combined supply and secondary supply competition**

In the case of combined supplies (and to some extent secondary supplies<sup>6</sup>) a different set of factors are relevant when considering what access price method may be appropriate. In particular, combined suppliers will need physical access to the undertaker's network in order to introduce their water<sup>7</sup>, and by definition this will require more consideration of the actual costs incurred as a result of access.

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<sup>6</sup> The paper which refers to the secondary undertaker providing a supply of water to the point of connection to the primary undertaker's network.

<sup>7</sup> Or to receive water from the secondary undertaker.

We would also want to encourage access at points on the network that helped to reduce constraints and make network management more efficient, rather than the opposite. We would want to use an access price method that allowed us to set locational signals to encourage efficient access.

Combined access pricing also needs to ensure network investment is efficiently incurred, looking to patterns of growth or shifting demand in the future. We would need to ensure licensees' investment decisions were correctly made, and that undertakers took rational decisions on investment as part of a coherent strategy that included licensees' activities. We would want licensees to be able to enjoy the benefits of efficient entry (where their choices allowed more expensive investment to be deferred or replaced). But we would also want undertakers to be able to recover their network costs efficiently incurred.

For these reasons, a combined supply pricing method will need to ensure recovery of current costs as well future investment. The method is more likely to require a case-specific approach, taking account of geographic factors.

### **3.1.3 Our proposals**

We recommend that the Government should remove the Costs Principle from primary legislation, and replace it with a set of criteria relating to access pricing. Ofwat would have flexibility to specify access price methods that are appropriate for different access arrangements, within the framework of these criteria.

Whilst we make a firm recommendation in relation to the removal of the Costs Principle, the criteria to replace it and the specific access pricing methods we may choose will need to be discussed further with stakeholders.

#### **Access pricing criteria**

We ask the Government to set out general criteria in legislation and empower Ofwat to decide the specific access pricing method(s) whilst having regard to those criteria. Some criteria would always apply, whichever access route is considered. Others would be weighted by Ofwat, allowing us to balance different methods and the effects on competition and customers. Whatever access pricing methods we decided to employ would depend on the extent of unbundling in the sector.

We propose that these criteria should include the following minimum criteria for all pricing methods:

- Pricing that promotes effective competition.
- Protection of services to ineligible customers (which can be reduced to protection of minimum service levels for all customers as the market is increased in size).
- Non-discrimination between an incumbent's downstream arm and its competitors, and between different customers.
- Entrants pay only for services received and required.
- The costs of an efficient operator of non-contestable (natural monopoly) services can be recovered.

- Incumbents to be exposed to market risks and incentives for contestable services.
- Compatibility with competition law.

Other weighted criteria which will depend on the situation when an access price method is set could include:

- Desirability of geographic price signals for entrants and incumbents.
- Stability of network access prices (to avoid short term price volatility and to help with planning long term investment).
- Maintaining those cross-subsidies which Government has said are desirable and which are compatible with the legislative framework.
- Efficient entry (productive, allocative, dynamic).

In addition to the proposals on the current regime the July paper also set out wider changes in competition which included the possibility of accounting, legal or structural separation. As set out in the consultation on 'setting price limits 2010 – 2015 framework and approach'<sup>8</sup> we consider that accounting separation is likely to be a necessary step to facilitate competition and to ensure that there is no unfair discrimination between internal and external customers for access to services. It can also help to properly expose costs used in the specification of access price methods.

#### **Recommendations**

- To remove the Costs Principle from the statute.
- To replace it with a set of general criteria for access pricing and require Ofwat to decide the specific method(s) for access pricing having regard to these criteria.

## **3.2 Eligibility threshold**

In the July paper we recommended a reduction in the threshold. We indicated that we would prefer a single reduction rather than a stepped approach. We also noted that 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.

### **3.2.1 Responses**

Respondents generally agreed with the proposal to reduce the eligibility threshold, but emphasised that other changes are needed in the WSL regime in order for it to have any material impact. Most respondents believe the threshold should eventually be zero (i.e. a market of all non-households), but there were mixed views with no specific industry divisions as to whether this should be achieved by a single or stepped change. Several respondents, notably large user customers, highlighted the

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<sup>8</sup>[http://www.ofwat.gov.uk/aprix/ofwat/publish.nsf/AttachmentsByTitle/pr09\\_methodologypaper181007.pdf/\\$FILE/pr09\\_methodologypaper181007.pdf](http://www.ofwat.gov.uk/aprix/ofwat/publish.nsf/AttachmentsByTitle/pr09_methodologypaper181007.pdf/$FILE/pr09_methodologypaper181007.pdf)

need for a clear timetable of changes to be set out in advance.

Further issues were raised around the risks of unwinding cross subsidies between smaller customers, the problem of some small businesses being un-metered if the threshold is dropped to zero (or near-zero), and the potential problem of households being eligible to switch by virtue of them being part of mixed-use premises (e.g. the flat above a shop, both of which share a single supply to the 'premises'). A detailed summary of the responses is set out in annex one.

### **3.2.2. Proposals**

As we proposed in the July paper, we recommend to Government that the eligibility threshold should be reduced to zero. However we consider that there should be an interim step to allow all involved to develop appropriate processes for the effective management of customer switching. There should be a clear commitment to a zero threshold at a firm point in the future. We would encourage the initial reduction to take place by the end of 2008, with a reduction to zero to follow at a set time in the future.

We consider that the changes to the threshold should be made as soon as possible. Even without a change in the Costs Principle, there is some scope for benefit as it will signal that a larger market is opening, which should enable businesses to build their business case over a period of time. A larger market will also reveal more information about retail costs, particularly if more customers switch. Water undertakers would be able to use this information to understand better what costs are avoidable, and could begin to anticipate what a set of 'standard' costs might be. In turn, we would expect water undertakers, by using their knowledge of standard prices, to significantly reduce the time taken to negotiate customer access prices. While it would still be negotiated access as set out by the Costs Principle, many aspects of the negotiation would be similar to ex-ante published access prices.

We have considered the costs and benefits of lowering the eligibility threshold.

The benefits of a lower threshold include:

- a greater likelihood of effective competition, because entrants are more likely to be able to exploit scale economies in retailing;
- wider availability of competition benefits, since more customers would be able to gain from competition by switching supplier;
- greater clarity in access pricing and the potential to incorporate more aspects of ex-ante publication of prices for classes of customers.

The costs of a lower threshold include:

- implementation costs of setting up the infrastructure required to support a larger eligible market (for example a Customer Switching Authority which would ultimately be needed if moving to a zero threshold);
- a potential increase in the magnitude of any adverse impacts from competition (for example stranding of assets).

We have set out some of the benefits of competition in chapter five of this document. These benefits include customer price reductions arising from greater cost efficiencies stimulated by competition, greater consumer choice and innovation. We are aware of respondents' concerns regarding mixed use premises, for example small shops with integral flats. We will consider this issue when we revisit the definition of premises, although an interim reduction of the threshold to 5MI would avoid the issue for now, giving us time to consider a long term solution.

The responses to the July paper have caused us to think further about moving to a zero threshold in a single step. The main argument in favour of a stepped approach is that a reduction to a zero threshold may take time to implement because time would be needed to develop the supporting infrastructure, particularly the customer switching mechanisms. In this case, an intermediate reduction which would work with the current infrastructure may allow at least some competition benefits to be realised sooner.

We recommend that the threshold is reduced to 5MI (approximately 27,500 customers) as an initial step. At a fixed point in the future, to be agreed in discussion with Government (but ideally within two years of the reduction to 5MI) we recommend that the threshold is amended to include all non-domestic users (approximately 1,250,000 customers).

The current customer transfer protocol should support a market of around 25 - 30,000 customers; hence 5MI would be the most appropriate interim step to take as it is the biggest market that can be created without incurring significant costs of additional switching infrastructure. Without a change in the Costs Principle the effects of this change may be limited. But it will allow entrants to prepare for the change and offers some benefits in terms of economies of scale, as well as driving a need for a more ex-ante system of published access prices which should simplify business decisions for new entrants by providing greater transparency and certainty.

In the intervening period before the threshold is reduced to zero we will work with the industry to develop a switching authority which could deal with larger numbers of customers that would become eligible to switch. It is not yet clear whether a single customer switching authority is more desirable than several similar providers (each of which, for example, may be responsible for a market that comprises a number of linked geographic markets based on several water undertakers' areas)<sup>9</sup>. However, it is important that a single set of switching rules is used. We will consider the options and consult further on this issue at a later date as it is important to keep the costs of setting up the market as low as is feasibly possible.

One example of such a switching authority is the Central Market Authority (CMA) in Scotland. All the costs of setting up the CMA, and the costs of its operation up until market opening, were allowed for in the 2006-10 Strategic Review of Charges

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<sup>9</sup> In its 2000 paper 'water competition a way forward' Logica stated that 'There are numerous benefits if the supply point and settlement systems required to support the competitive water market are provided by a single, independent body for the whole market. The main benefits are lower costs and error reduction.'

(SRC). Following market opening, CMA costs will be shared between Scottish Water and licensed providers in the proportions 1/3 to 2/3. It is planned that the 2/3 share borne by licensed providers will be allocated between them according to their proportion of supply point registrations, where the supply are weighted according to the connection size. The 'Go Active' date for the CMA was 1 October 2007 – from this date the CMA was self-sufficient and had a system in place for registering switchers in the 'pre-market' (Licensed Providers are entitled to enter pre-contracts with customers for the provision of services from 1 April 2008 and to register these with the CMA). It took approximately six months to get the CMA to this position. The market is due to 'Go Live' on 1 April 2008, although the Central Systems themselves will be live from February 2008.

The costs of a central switching agency in England and Wales could be different due to the size and structure of markets. For example, there may be economies of scale to exploit. More detail on this issue is set out in chapter five which looks at the potential costs and benefits of competition.

### **Recommendations**

- The eligibility threshold should be reduced to zero, but with an interim step to allow all involved to develop appropriate processes, and with a clear commitment to a zero threshold at a firm point in the future.
- The interim step should be set at 5MI.
- We recommend that the first change to the threshold should take place within a year and that the reduction to zero should happen within two years of that.

### **3.3 Definition of premises**

Ofwat's guidance on eligibility states that 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).

In the July paper we set out our proposal not to review the definition of premises at this time. We also considered the possibility of whether we should allow the aggregation of ineligible premises (those that use less than 50MI of water per annum) under common ownership, but on balance recommended that we do not consider aggregation further. If the threshold is reduced to zero in the next few years all premises will be eligible anyway.

### **3.3.1 Responses**

The majority of respondents agreed with Ofwat's proposal not to change our current guidance on the extent of 'premises', although some licensees asked for our existing guidance to be clearer. However, respondents noted that a reduction in the threshold may have an impact on the definition of premises.

Overall, most respondents agreed with Ofwat's proposal to not consider, at this time, changing the premises definition to allow multi-site aggregation as a way of meeting the eligibility threshold. Water undertakers all supported the proposal not to allow multi-site aggregation while some licensees and customers were in favour of allowing multi-site aggregation. However, the majority agreed that with a zero threshold multi-site aggregation is not needed (because all premises are then eligible). A detailed summary of the responses is set out in annex one.

### **3.3.2 Proposals**

#### **Definition of premises**

We recommend that the current guidance on the extent of premises remains unchanged, while the threshold remains above zero. However, we consider that if the recommended reduction in the eligibility threshold to include all non-household premises takes place then issues may arise regarding mixed-use premises. Therefore we will re-visit the definition of premises when we revise our guidance to take account of changes in the threshold to zero.

We will also revisit the definition of 'principal use' which helps us define for the purposes of WSL what is or is not a 'household' (i.e. ineligible) premises. At the moment, premises supplied with more than 50MI of water and which use more than 50% of that supply for non-domestic purposes are deemed eligible. We will consult on any appropriate changes to the definition of premises when we revise our

guidance in the light of changes to the threshold. The guidance will be developed in conjunction with stakeholders.

### **Multi-site aggregation**

We suggest that multi-site aggregation should not be considered at this time. We recommend in section 3.2 that the threshold is reduced to include all non-household customers. Therefore multi-site aggregation of sites that do not meet the volume requirement is unnecessary.

#### **Recommendations**

- There should be no changes to the definition of premises at this time.
- We will keep the definition of premises under review.

### **3.4 Contractual aggregation (in-area trading)**

A licensee that is related to a water undertaker (an associate 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 are defined by standard licence condition 7(2)(a) as activities authorised by the licensee's water supply licence. This limitation is imposed by standard licence condition 7 of water supply licences and by legislation (section 2(d)(iii) WIA91). We stated in the July paper that we consider that this restriction should be removed to facilitate national contracts for all licensees.

#### **3.4.1 Responses**

The majority of respondents (water undertakers and others) agreed with our proposal to ask the Government to change legislation to allow trading by associate licensees within the area of their associated water undertaker. Such a move would enable associate licensees to supply retail services to customers on a national basis, which they are not currently allowed to do (but which independent licensees are). Water undertakers reiterated the need for in-area trading to be carried out at arm's-length and with appropriate cost allocation.

#### **3.4.2 Proposals**

We recommend that the Government changes legislation to allow in-area trading by associate licensees. In turn we will amend our guidance to allow in-area trading, whilst ensuring that the arm's-length trading between a water undertaker and its associate licensee is appropriately enforced.

If the structure of the industry changed in the future, the distinction between associate licensees and water undertakers may need to be revisited.

### **Recommendation**

- We recommend that legislation is changed as soon as possible to permit in-area trading.

## **3.5 Licence application fees**

In the July paper we proposed to abolish licence application fees payable to Ofwat by applicants to reduce barriers to entry.

### **3.5.1 Responses**

The majority of water undertakers disagreed with our suggestion that removing licence application fees (payable as a one-off fee to Ofwat) could reduce a barrier to entry for potential licensees. Many felt that the current fee was not in fact a barrier, and the cost of asking Defra to remove the fee via an amended Statutory Instrument would outweigh the benefits of so doing. Only one licensee responded stating that licence application fees are a minor barrier to entry. A detailed summary of responses is set out in annex one.

### **3.5.2 Proposals**

On balance we do not propose to pursue the removal of licence application fees. The cost of changing legislation is likely to outweigh the benefits.

The highest level of fee is £2,500 for a combined licence application. Compared with a likely business set up cost of around £0.5 million, the licence fee is unlikely to be a significant amount.

### **Recommendation**

- We recommend that no changes are made to the current licence fee arrangements.

## **3.6 Supplier of last resort**

In the July paper we noted that there is a general lack of understanding among customers about their current security of supply, and that customers have expressed concerns that there is no statutory duty on the incumbent undertaker to act as a 'supplier of last resort' (SoLR) in the event of licensee insolvency or withdrawal from the market. We believe that the current legislation effectively mirrors a SoLR regime and therefore do not propose to seek a change to legislation.

### 3.6.1 Responses

The majority of respondents (a mix of undertakers, licensees and customers) either did not agree with our suggestion that the legislation as it stands effectively mirrors a SoLR regime, or said it only applies for retail, as water undertakers cannot be expected to retain spare resource capacity in the case of combined licensee failure.

Respondents did agree that the current law (sections 66G-H WIA91) on 'strategic supplies' (which provides the basis for SoLR for combined supplies) is flawed and needs to be amended by Government.

We also proposed that water undertakers should publish their SoLR obligations and duties, so all customers considering switching would have some reassurance that they could switch back. Respondents generally argued that information about water undertakers' obligations is already public, but added that it should be Ofwat (not water undertakers) who did any further work on this. A detailed summary of responses is set out in annex one.

### 3.6.2 Proposals

We agree with respondents that there is a stronger SoLR regime for retail supplies compared with combined supplies. Where the physical availability of resources is not an issue, retail customers should be taken back by the incumbent. We do not propose to pursue further changes in the law on SoLR for retail supplies. However, we do intend to take up with water undertakers the proposal that they should offer a default tariff to returning retail customers and make it clear that they will take retail customers back.

For combined supplies, the proposed changes to the strategic supply regime will result in further protection for combined customers. We do not intend to pursue further changes in the law other than this. However, we do propose to ask water undertakers to develop a set of tariffs for returning combined supply customers, to be approved as part of the charges scheme. These default tariffs may in some cases need to be higher than standard retail tariffs (for example, if investment in water resources was deferred as a result of switching).

We also intend to produce an information note clarifying water undertakers' current SoLR duties and obligations under the WIA91. The existing 'Interim duty of supply' (section 63AC WIA91) states that where a licensed water supplier ceases to supply any premises with water it shall be the duty of the water undertaker to continue the supply of water to the premises until a notice of disconnection is served or a supply is made under section 52 or 55 WIA91. However, this 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 and probable future supply obligations. Alternatively, an introduction of water is designated as strategic (under sections 66G and 66H WIA91), if, without the introduction being made, there is a substantial risk that the water undertaker would not be able to maintain supplies to its own customers as well as supplying the licensee's customers for domestic purposes.

Our strategic supplies guidance also states that, if a customer requires a stand-by or back-up service this may affect the water undertakers water resource plans and might have implications for the access price. The water undertaker should price for any such non-statutory service transparently to show the customer and the licensee the value of this extra security.

### **Recommendations**

- We recommend that the current legislation does not need to be changed for retail supplies.
- We will require water undertakers to develop and publish a default tariff for all returning retail customers.
- We recommend that Government should pursue the changes to the strategic supply regime to allow further protection for combined licensees and their customers.
- We will ask water undertakers to develop and publish tariffs for returning combined supply customers, to be approved as part of the charges scheme.
- We will publish an information note clarifying water undertakers' current SoLR duties and obligations under the WIA91.

## **3.7 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 a water undertaker (for example by sewerage undertakers deferring capital sewerage schemes). We set out in the July paper 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.

### **3.7.1 Responses**

There was overall agreement that retail competition in sewerage should be included as part of the WSL regime. Only three respondents (two water undertakers) disagreed, raising issues about costs and benefits. The majority of respondents highlighted a number of difficulties in introducing combined competition and questioned whether there are any benefits to be gained by doing so.

### **3.7.2 Proposals**

We propose to ask Government to amend primary legislation to allow retail competition for sewerage as part of the WSL regime, as soon as possible. We do not propose to pursue combined sewerage competition at this time. However, with

our industry advisory groups we will conduct further work to assess the scope for combined sewerage competition in the future.

One of the main benefits from the introduction of retail competition in sewerage is that licensees will be able to bill customers for both water and sewerage, therefore under the Costs Principle avoiding further costs to the incumbent supplier. Licensees will therefore be on a level playing field with incumbents that are already

able to offer combined bills. This change should be straightforward to implement using the industry's experience of WaSCs billing the WoCs for sewerage services provided on their behalf.

### **Recommendations**

- That Government should allow retail competition for sewerage as part of the WSL regime as soon as possible.
- That we will explore further possibilities for combined sewerage provision.

## **4. Update on options for longer term change to the water and sewerage industry**

Chapter three presents the conclusions of the first part of Ofwat's competition review, which has focused on making the current WSL model for competition more effective. We have assumed that the WSL regime could be used as the basis for further development of competition.

This chapter considers some additional approaches to promoting competition in the water and sewerage sectors, which were highlighted in the July paper for consultation. It summarises the responses to the July paper (more detail is in annex one).

These and other issues will be considered in further detail in the paper we propose to publish in the spring, looking at possible wider reforms based on the emerging conclusions of the second part of Ofwat's competition review.

### **4.1 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 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.

Some respondents (notably water undertakers) were concerned that the costs of accounting separation may outweigh the benefits. However most stakeholders think accounting separation is essential for competition to take place. Customers were particularly in favour of the transparency that could result from accounting separation.

Accounting separation is common in other utility sectors (electricity, gas, and telecommunications) and has proven very effective in facilitating the development of competition. It can provide many benefits. For example, it can provide greater visibility of costs incurred and margins earned in providing services. This leads to a better understanding of the costs incurred by incumbent operators in providing services to customers, competitors and customer groups. Greater understanding of costs can facilitate more cost reflective tariffs.

Accounting separation (underpinned by transparent cost allocation) also allows customers to see which costs and margins are involved in the services they are using. This allows retailers to unbundle different services in order to provide greater choice to customers and more scope for competing retailers to offer different packages to suit different customers' needs.

Accounting separation also provides a more level playing field for the development of competing service offerings. Transparent cost allocation makes it clearer what costs the incumbent incurs when it supplies its own notional 'downstream' retail arm with services which in turn enables the 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 overtly discriminating on prices between its own notional downstream arm and competitors.

Our accounting separation proposals will be underpinned by new work on cost allocation. Cost allocation involves identification (and reporting) of the costs associated with different services or functions. This requires an understanding by companies of the costs involved in business activities which provide different services to their customers. Some costs will be directly related to the provision of a particular service; others will be common to one or more services and are apportioned across the services.

We will take forward our proposals to require each company to identify clearly and report separately on each key area of its business. This will aid transparency, improve cost reflectivity, identify competitive opportunity and make entry to the market simpler. While we will consult on this issue in more detail, it is likely that companies will be required to separate out for accounting purposes their notional retail business, their network business and their production / treatment businesses.

#### **4.2 Structural separation**

Most respondents, other than many water undertakers, stated that structural separation would encourage effective competition. An advantage of structural separation over accounting separation is that costs are clearly allocated to specific businesses and no residual conflicts of interest which could manifest in behavioural discrimination occur. There would no longer be common ownership of the network and the retail/wholesale supply businesses of the incumbents.

Most water undertakers stated a preference for accounting separation over structural separation, believing structural separation would be unlikely to be efficient in the short or medium term. One water undertaker (United Utilities) said it welcomed the debate on structural separation. They believe it could bring benefits as the existing water undertakers would be divided into a greater number of true independent entities, who would concentrate on improving efficiency and may wish to expand their functional activities horizontally through mergers and acquisition to benefit from economies of scale.

Structural separation could bring greater benefits than accounting separation. We will explore the issues further (including the costs as well as the benefits) and set out for further debate more detailed proposals in our spring 2008 paper.

#### **4.3 Household competition**

Respondents identified a number of potential barriers to effective household retail competition, such as low potential margins, costs of systems, the limited scope for

significant cost reductions and the limited sanctions available for non-payment. A number of respondents (both licensees and water undertakers) nevertheless believed competition should be extended to households. Further work is required to identify whether any of the potential barriers would prevent water customers obtaining benefits similar to the way gas and electricity customers have. We do not propose an extension of competition to households in this paper because our consideration has been limited to the WSL regime, but we will look further at household competition in our spring 2008 paper.

#### **4.4 Competition in the 'production' of water**

Respondents stated that the main barriers to entry are the existence of 'spare' raw water, regulatory restrictions on inputs to water undertakers' systems and the large difference between average and marginal costs given uncertainty over demand and supply requirements. Several water undertakers opposed the idea of releasing water resources as they are unclear on how they could then fulfil their supply obligations in the statutory Water Resource Management Plans. The second part of the competition review will examine these issues in more detail.

One important aspect is the cost of environmental improvements, and who should fund these in a competitive market. At present, water undertakers fund this investment, and in a competitive market all licensees would contribute to the costs of environmental improvements directly or via access charges. There may be scope for these costs to be recovered from other sources (i.e. not from water undertakers) but we do not pursue this further in this paper.

#### **4.5 Competition in abstraction**

Most respondents suggested the existing trading regime was not effective and several undertakers said the Environment Agency's duties to the environment were not compatible with promoting competition. Some (including Water UK and the EA) said it is the Environment Agency's role, not Ofwat's, to increase awareness about trading, while others said it would be helpful if we were to publish more information about trading possibilities.

Promoting competition is not a duty for the Environment Agency. Competition and trading nevertheless have a potentially important part to play in the delivery of the Environment Agency's duty to manage water resources as well as Ofwat's duty to consumers. The Environment Agency is keen to work with Ofwat to increase awareness of the existing potential for competition in abstraction, and see if the regime can be improved.

## 5. Costs and benefits of competition

This section considers some of the general benefits and costs of competition with reference to other industries, and the costs and benefits of the recommendations in this paper.

The recommendations in this paper are intended to make the current WSL regime work better. They are incremental improvements to the existing regime, rather than a return to the ‘first principles’ of competition. The WSL regime was subject to extensive consultation in July 2002 and debate on the Water Bill 2003 (and its impact assessment) and the subsequent implementation of the Water Act 2003.

The threshold reduction is the change most likely to incur additional costs, however the proposed initial step to 5Ml would use the current infrastructure and so the extra costs are likely to be limited in the first instance. The step to zero would require additional systems to handle switching and will have an associated cost. For example the cost of setting up the Central Market Authority in Scotland, and operating it for the first year before market opening, is expected to be £2.5million (in 2003-04) prices or £2.9million in current prices. We will include the potential costs of introducing appropriate switching infrastructure in an impact assessment of proposals in the second part of the competition review.

General benefits from competition may include:

- customer price reductions;
- improved quality of service and new services to customers; and
- customer choice.

These may arise variously as a result of:

- elimination of monopoly rents;
- greater incentives for productive efficiency (more efficient use of existing assets);
- greater incentives for allocative efficiency from better pricing signals (for example customers consume and pay for the services they actually want)
- probably most importantly, greater incentives for innovation delivering dynamic efficiencies and developing new services faster for customers (for example multi-utility products).

Competition can help address these challenges and contribute to the delivery of the Government's objectives for the water industry as a whole<sup>10</sup>. For example competition could:

- stimulate a more dynamic retail sector, providing better services to customers and helping to reduce water wastage;
- provide a greater focus by water companies on improving efficiency and reducing costs of supply (including leakage), making water more affordable;

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<sup>10</sup> See 'Extending opportunities for competition in the water industry in England and Wales', Defra/Welsh Assembly Government 2002

- encourage more efficient allocation of water resources, reducing the potential impact of the water industry on the environment;
- drive more innovation and dynamism in technology and processes, encouraging companies to find more efficient ways to abstract, treat and supply water, to help to address the impact of climate change, reduce the carbon footprint of the industry and improve the quality of the environment.

In working towards the development of a competitive marketplace it is important to ensure that there is appropriate protection of public health and that, over time, the benefits of competition are captured and the regulatory burden can be lightened by regulatory withdrawal wherever possible.

In general the introduction of competition for contestable activities in other network industries has led to benefits for both consumers and the industry. For example, competition in the wholesale and retail energy markets has brought considerable benefits to industrial, commercial and domestic customers.

The National Audit Office (NAO) carried out a study<sup>11</sup> with data up to June 2000, which found that 6.5 million domestic customers (around one in four) had switched suppliers<sup>12</sup>. These customers had seen their bills fall by a total of £299 million since the start of competition, a 15% reduction in real terms and an average of £45 per customer. About half of the reduction was due to competition and the rest was due to reductions in Ofgem's price caps. The NAO considered that competition had allowed Ofgem to develop a clearer view of costs and available price reductions.

Ofgem's reduction of price caps for distribution and supply companies since competition began meant that customers who had not switched were also paying lower prices, by an average of £23 per customer. Ofgem believed that competition may have helped to force down the prices paid to electricity generators for the electricity they supplied.

More recent data shows that energy customers can still make extra savings by switching from incumbent suppliers with average savings for dual fuel customers around £107 for prepayment customers, £91 for standard credit customers and £68 for direct debit customers. Domestic suppliers are also visibly seeking to improve the service they offer customers with complaints statistics showing a steady decrease in unresolved customer grievances.

In a recent business customer survey about the partial liberalisation of the postal service, more than half (54%) agreed that competition has improved choice and 39% believe competition has improved Royal Mail's quality of service<sup>13</sup>.

The costs of competition may include potential loss of vertical economies of scope if unbundling is implemented. A fuller review of the costs will be conducted as part of

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<sup>11</sup> Giving domestic customers a choice of electricity supplier (2001), National Audit Office.

<sup>12</sup> Note that this paper does not propose to extend competition to households, but this will be addressed as part of our spring 2008 paper.

<sup>13</sup> Postcomm – competitive market review 2007 (Business Customer Survey).

the impact assessment of proposals in the second part of the competition review. Other costs of competition include the implementation and operation of the competitive regime by the regulator and the costs incurred by companies operating in the market. For incumbents these include the costs of addressing changes in regulation, and meeting competition from new entrants. Costs will vary significantly depending on the sector and the mechanism chosen for competition. One example of costs is illustrated by Phoenix Natural Gas (in Northern Ireland) estimated (in a regulatory impact assessment) that some of its immediate costs in delivering competition included £150,000 for network code modifications, £300,000 for the opportunity cost of management time and £600,000 for software systems, the total cost of delivering competition was £17,430,000<sup>14</sup>.

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<sup>14</sup> <http://www.detini.gov.uk/cgi-bin/downutildoc?id=1223>.

## 6. Next steps

Many of the proposals in this paper will require changes to legislation, on which we propose to work with Government to take forward, including with the Government's review of competition. There are other proposals to improve the WSL regime which Ofwat will take forward without legislative change. For example, under the WSL regime we will continue to work with our industry groups to develop a greater understanding of what constitutes an ARROW cost, (including work from the forthcoming determination under section 66D WIA91 by Ofwat to be published early in 2008). We will also publish information on supplier of last resort obligations and rights, and continue to work with stakeholders to promote awareness of competition, and other opportunities for combined supply.

This paper represents the conclusions of the first part of Ofwat's competition review, which has focused on making the WSL regime more effective. It will be followed in the spring by a paper which will draw on the second part of the review, looking at wider changes. As set out in the July paper, in the second part of its competition review Ofwat is undertaking wider examination of competition in the water industry, looking beyond some of the assumptions of the WSL model, for example, that of maintaining vertically-integrated monopolies and excluding household competition. The paper in the spring will consult on the emerging conclusions.

The July paper raised some of these wider issues. A brief summary of responses to this part of the paper was set out in chapter four of this paper and detailed responses are included in annex one. We will continue to examine all the relevant issues in the second part of the competition review.

This work will also include taking forward a number of specific work streams:

- Accounting separation - this will require each undertaker to identify clearly and report separately on each key area of its business. This will aid transparency, improve cost reflectivity, identify competitive opportunity and make entry to the market simpler. While we will consult on this issue in more detail, it is likely that companies will be required to separate out for accounting purposes their notional retail business, their network business and their production and treatment businesses.
- Abstraction – we will work with the Environment Agency to further explore the scope for competition in abstraction and the recovery of abstraction charges. This will include involving the Agency in our industry working groups.
- Competition in the provision of combined sewerage services – we will research the possibilities for combined sewerage provision further with our industry working groups.
- A review of the water and waste water value chain to help identify where there are opportunities for contestability and thus ensure we focus our efforts appropriately.

- A market analysis project to act as a platform for our work on competition going forward and further identify whether there may be work we can do to reduce barriers or promote competition.

We will also consult on our amended inset appointment guidance, to streamline the application process. We are currently consulting on our updated CA98 guidance<sup>15</sup> as part of our enforcement policy, although these two projects are less directly related to the wider review of competition.

The key next steps in the review of competition and the other linked work streams are:

- The updated CA98 guidance was published for consultation on 13 December 2007.
- We will publish the updated inset appointment guidance early in 2008.
- We are holding a industry workshop to introduce the cost allocation/accounting separation project on 25 January.
- We will issue a consultation paper on wider competition and the results of the market analysis project in spring 2008.

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<sup>15</sup>[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/ca98\\_guidanceapplication\\_cons131207.pdf/\\$FILE/ca98\\_guidanceapplication\\_cons131207.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/ca98_guidanceapplication_cons131207.pdf/$FILE/ca98_guidanceapplication_cons131207.pdf)

## **Annex One - Responses to the July 2007 consultation**

We received responses from 35 stakeholders including 18 statutory water undertakers operating in England and Wales, Water UK, the Consumer Council for Water (CCWater), the Environment Agency, 3 water supply licensees (referred to in this document as 'licensees'), 8 business customers and 6 other stakeholders. A list of respondents is at the end of this annex, and copies are available in our library (except two replies that wished to remain confidential).

Chapters three and four of the main paper set out in detail our proposals for going forward, in the light of responses to the July paper. Therefore this annex only briefly summarises our responses to avoid unnecessary duplication.

Many respondents made general remarks about the need for a robust analysis of the costs and benefits of competition. We have considered these comments and have discussed this issue further in chapter five of the main document.

### **3. Options for change to the current competition regime**

#### **3.1 Approach to access pricing**

**Question 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.**

Most respondents (including all licensees, all business customers, six water undertakers and one stakeholder) agreed in principle that the current access pricing regime inhibits the development of effective retail competition, some citing the absence of switchers as evidence.

One of the key reasons for this was the fact that insufficient margins are available to new entrants as a result of the current pricing regime. Some argued that retail activities represent only a small part of a water undertaker's total costs which makes it difficult to offer large discounts.

However several respondents felt that the current pricing regime should be retained for combined access, where the discounts available to new entrants are likely to be more attractive (borne out by the indicative discounts on offer from some companies).

Four water undertakers agreed that the current access pricing regime inhibits competition, but did not agree that this inhibition meant that the Costs Principle was wrong. The following additional points were raised:

- One water undertaker felt that the current regime is designed to inhibit inefficient competition.
- One stakeholder argued that Ofwat's current approach implicitly and incorrectly assumes that the incumbent is an "average" cost based organisation immediately prior to competition but, as soon as competition arrives, that it is suddenly transformed into an efficient "marginal" cost operator.
- Another stakeholder stated that competition will fail where it artificially promotes entry for inefficient entrants. Retail competition should be priced differently to maximise the opportunities for efficient entry.
- A water undertaker stated that ECPR ensures that competition promotes pareto efficiency in the use of scarce resources, and another water undertaker noted that ECPR fits the current structure of the water industry and Government's stated objectives.
- One water undertaker argued that any decision to amend the current access pricing regime should be based, in the large part, on the conclusions from the market analysis and Ofwat's associated cost benefit analysis of options for change.
- One licensee and a business customer felt that Ofwat should provide water undertakers with further guidance on the Costs Principle and what "avoidable cost" elements should be included.
- Another stakeholder argued that any methodology which seeks to protect the income and profits of the present monopoly incumbents will deter the development of competition.
- CCWater and a water undertaker noted that any extension of competition should not be at the expense of ineligible customers.

## **Our response**

We do not believe the current 'one size fits all' approach to access pricing provides sufficient flexibility to address different access arrangements. We do not expect retail competition to flourish under the current regime, although some customers may switch. There may be potential for more combined supply competition in the light of recent indicative access price discounts published by undertakers in October and November.

### **Question 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?**

Of the 30 respondents to this question, 17 agreed in principle with this proposal as it would allow a greater degree of flexibility; most of these also said that the principles set in legislation must be clearly stated and that all stakeholders should be consulted and involved in the process of developing the detail. Several respondents highlighted the fact that changing legislation can take a significant amount of time, and one respondent suggested including any principles in secondary legislation in case further changes were necessary. Five water undertakers, one licensee, one business customer and another stakeholder did not support this proposal. The main arguments against the proposal were that principles are open to different interpretations and that parliament should remain responsible to ensure consistency.

The remaining four respondents' comments are reflected in the text below. The following additional comments were made:

- One water undertaker felt that the consultation document does not provide sufficient evidence or argumentation that the benefits of vesting the regulator with discretion to amend the pricing regime outweigh the associated costs and risks.
- One business customer argued that it is essential that Ofwat helps to facilitate market competition in the short and medium term by considering how it can more effectively use existing powers. However, one water undertaker felt that artificial short-term, pricing should not be introduced simply to facilitate competition.
- One stakeholder said that the legislation should follow general competition principles: that a downstream operator should be entitled to the same margin as the incumbent's own notional downstream business would require to operate as a stand-alone basis.
- Another stakeholder stated that if new legislation is introduced then the end objective should be specified in the legislation, merely in the form of a 'target' or 'goal'. It should not however be specified in a prescriptive way.
- One water undertaker stated that it is important for there to be a robust appeals mechanism and for all stakeholders to be fully involved in developing the detail.
- Another water undertaker noted that if principles are to include cost reflectivity then there must be consistency between tariffs and access pricing in order to avoid cherry-picking and introducing new cross-subsidies.
- One business customer stated that some of Ofwat's priorities may conflict with the development of a competitive market; therefore another independent body (e.g. the Competition Commission) may be better placed to develop the detail. However, one water undertaker felt that the iterative nature of the development of competition supports the notion that it is more appropriate for an economic regulator to develop the detailed competition framework.
- One stakeholder commented that the original DEFRA consultation in 2002 stated this intention; however Ofwat now appears to be ignoring the principles in its concern to get any kind of competition working.
- CCWater felt that it is vitally important that the principles surrounding the pricing regime are clearly stated and made publicly available.

### **Our response**

We think it is appropriate that Ofwat has flexibility to develop access pricing methods within a set of general criteria agreed by Government. These criteria should be consulted on and clearly set out in legislation. Proposals for what those criteria should include are set out in section 3.1.3.

**Question 3a: In considering appropriate access pricing regimes: Do you think that there should be different access pricing regimes for different parts of the supply chain? If so why and for what parts?**

There were only 16 respondents to this question; nonetheless, they generally supported the possibility of having different access pricing regimes for different parts of the supply chain. Nine respondents agreed in principle, including five water undertakers, one business customer and three other stakeholders. One of the

reasons given for this included the need to reflect the different characteristics of the supply chain. One licensee disagreed, saying that if a single regime reflected the all of the principles in the consultation, then it could be applied throughout the value chain. A further six respondents did not rule out the possibility of different pricing regimes happening in the future, but said this should not be considered until a decision has been taken on what markets should be contestable, and the existing absence of disaggregated cost information is redressed. Some respondents noted that our work on cost allocation will be useful in highlighting whether or not separate pricing regimes are needed. The following additional comments were received.

- One water undertaker stated that care needs to be taken in designing access pricing regimes as there is a need to balance multiple objectives.
- Another water undertaker pointed out that there is a need for a number of different pricing arrangements to reflect the complexity of the water industry across the supply chain. However, a business customer maintained that over-complication of the market should be avoided at all costs.
- One stakeholder stated that access pricing should reflect the genuine added value of the applicable point in the supply chain, although a water undertaker felt that this would only be appropriate where the degree of contestability of the service varies.

### **Our response**

We believe different types of competition are likely to require different methods of pricing. We also agree with the comments from respondents that our ongoing market analysis and cost allocation work should inform any decisions on pricing methods for other parts of the value chain in the future. See section 3.1.3 for details on our work going forward.

### **Question 3b: In considering appropriate access regimes:**

**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?**

There was a mixed response to this question, with 29 respondents in total. Eleven respondents stated that it was difficult to compare the current access pricing approach in England and Wales with other approaches, because of the differences between individual regimes, the different types of product (when comparing with gas and electricity) and the difference in industry structures. Ten respondents, including eight water undertakers and two other stakeholders, highlighted the fact that the regimes in Scotland and New South Wales are not yet established; it was noted however that these regimes could offer potential lessons in the future. The remaining eight respondents made comments as set out below.

- One business customer felt that Scotland seems to have a more practical response to competition, which is more likely to work. However, a water undertaker argued that the Scottish Water approach is likely to increase the costs of capital for incumbents.
- One water undertaker felt that the regime in New South Wales seems unlikely to be successful in England and Wales given experience to date in trying to reach

agreement on other aspects of the regime. One business customer argued that the system in New South Wales provides an enviable level of flexibility.

- A licensee said that the regime in England and Wales is different, in that there has been no restructuring of the vertically integrated regional monopolies.
- Another stakeholder added that the main lesson to be learned from other utilities is that vertical integration of the supply and asset-owning businesses substantially lessens competition.
- One water undertaker pointed out that in gas and electricity the firms that charge for access do not themselves provide services to final customers.
- Another water undertaker pointed out that unlike the energy sector (which is often used as comparison but in reality is very different) the bulk of the cost base resides in the non-contestable elements of the value chain i.e. the distribution network and water treatment facilities.
- A further water undertaker stated that licensees in water are not sourcing and supplying a cheaper product to the customer as is the case in the competitive gas or electricity markets in the UK.
- A business customer said that there is potential for economies of scale by combining water services to customers alongside other utility products.

### **Our response**

We are aware that the water and sewerage industry in England and Wales has attributes that make it difficult to compare with other countries or other industries. We consider there are lessons that can be learned from the regimes elsewhere, and we will continue to monitor their development, but equally we will ensure that protecting the interests of water consumers in England and Wales remains our focus.

### **Question 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?**

There were 26 responses to this question, providing a number of different suggestions. A key consideration raised by CCWater and a number of water undertakers in response to this question was the need to protect ineligible customers when developing an access pricing methodology. Ten respondents recommended that the current Costs Principle should be retained at least for combined competition, and there was support for the Costs Principle as an overall pricing methodology from six water undertakers. Other suggestions by respondents included the following:

- A standard average cost based retail price discount.
- An accounting cost approach to the calculation of retail discounts.
- A retail-minus fully-allocated cost approach vis-à-vis the Scottish regime for retail.
- A methodology that uses the cost analysis to provide a "bottom up" pricing methodology, providing cost transparency in all elements of delivery.
- Access pricing should be matched to functional disaggregation, and be built up using an activity based approach and average costs.
- A correctly designed access price will have the following elements:

- (a) Initial revenue base
- (b) Target revenues i.e. k factor adjustment
- (c) Scaling to target i.e. allocation of revenues to the displaced access activity
- (d) Subtraction of benefits brought by the added load.

The following additional points were raised:

- CCWater felt that it is premature to decide which is the most appropriate methodology until the principles for the pricing regime are developed and agreed. A business customer agreed saying that without a cost analysis, the scale and nature of potential cross subsidies are unclear. A water undertaker stated that it is irrational to propose new pricing methods when the current regime for common carriage has not yet been tested.
- Two water undertakers argued that any pricing methodology should improve guidance on cost avoidance and also avoid unintended cross subsidies; therefore it should retain the top down approach.
- A business customer and another stakeholder however, felt that a bottom up approach would provide cost transparency in all elements of delivery.
- One water undertaker felt that average pricing will allow easier access for new entrants but leads to higher costs for existing customers.
- One water undertaker stated that there is no pricing regime that can effectively protect ineligible customers and lead to meaningful competition. They felt that a decision must be made as to whether the likely future benefits of competition for domestic customers are sufficient to offset the additional costs that they will have to bear in the short-term, to affect a functioning market.
- Another water undertaker noted that the access pricing method should not enable cherry-picking of large customers on a marginal cost basis at the expense of ineligible customers.
- One water undertaker felt that for common carriage the current Costs Principle allows for competition only where it is clearly beneficial for the customer by avoiding inefficient market entry.
- One licensee suggested that potential entrants should not have to ask for customer-by-customer access prices and that the incumbents' own retail arms should be treated like new entrants in terms of access prices.
- A business customer felt that new entrants are more likely to be attracted to a market where the prices and economic signals are kept as simple as possible. Unnecessarily complicated wholesale mechanisms tend to favour incumbent companies and deter the development of an active competitive market.
- Another stakeholder commented that any approaches relying on marginal costs or costs avoided are very likely to fail margin squeeze tests applied by Competition Courts.

## **Our response**

Respondents provided many different examples and explanations in relation to access pricing methodologies, which we will consider further as we develop our thinking on access price methods. We will encourage licensees and customers to

continue to explore the potential for more competition in the current regime, as well as looking to what might replace it if that decision is taken. Sections 3.1.2 and 3.1.3 look at how we might specify access pricing methods in the future should the Government remove the Costs Principle from statute. In the interim we are still bound to use the method set out in section 66E Water Act 2003.

**Question 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?**

Responses to this question were mixed, with 10 out of 18 respondents generally considering that changes would be needed to cost reporting. Of these, one business customer and one water undertaker felt that the need for more transparency in cost reporting is important, and three water undertakers considered that any implications would depend upon the exact nature of the methodology employed. Two water undertakers requested that Ofwat should take into account water undertakers' workload commitments and cost implications up to the next price review when considering proposals for cost reporting. The following additional comments were made:

- One water undertaker felt that no changes to cost reporting are required for average cost or LRMC reporting. June return and price review current data is sufficient for prices to be set and regulated, as it is consistent with the existing regulatory processes for price controls.
- One water undertaker noted that some access pricing methods will result in a short-term increase in transaction costs and regulatory reporting. However, any regime that significantly increased competition would be expected to bring a commensurate decrease in the level of reporting requirements in the longer term.
- Another water undertaker argued that introducing the appropriate accounting systems and processes for new cost reporting proposals would be a costly and time consuming exercise and as this activity is not carried out at present, historical data would not be available.
- One water undertaker pointed out that the Scottish model would at least require separate accounting, which would impact on collection of costs and annual reporting.
- Another stakeholder felt that the WSL regime will not produce effective competition whilst the industry is dominated by vertically integrated monopolies, and collecting costs in other ways is unlikely to bring about the change required.

**Our response**

We believe greater transparency in costs is very important, for competition and for other work that Ofwat does. We are beginning work, in conjunction with stakeholders, on how to take that forward. We are encouraged by the positive reaction from many water companies about the need for better allocation of costs and their desire to be involved actively in our work. We are still at an early stage in our work, however, and have not reached any firm views on how costs could be reported differently or what access price methods should be employed.

## 3.2 Eligibility threshold

### **Question 6: Do you support Ofwat’s view that the threshold should be reduced? If not please explain why.**

Thirty-one stakeholders responded to this question; 19 respondents had no objections to reducing the threshold, but a number of those emphasised that other changes are needed for it to have any impact. The Environment Agency expressed concerns about reducing the threshold for entrants with their own source of water because there are implications for the management of supply systems during drought. Five water undertakers, one business customer and another stakeholder believed that the threshold does not need to be reduced. They felt that reducing the threshold is unlikely to have a significant impact and benefits will therefore not outweigh the costs. The remaining respondents did not specify a view either way. The following additional points were raised by undertakers:

- Reducing the threshold is unlikely to stimulate more competition because margins for retail as a fraction of the value chain for water supply services are rightly thin.
- It is inappropriate to reduce the threshold at this point if a substantially altered regime is going to be introduced.
- A threshold change should only be promoted after cost-benefit analysis of the alternatives.
- Below 50Ml/yr, savings for customers and margins for suppliers may be insufficient and newly-eligible customers could become disillusioned.
- Even with no threshold, retail competition will not bring sufficient savings for customers to justify the social and financial costs.

### **Our response**

As we said in the July paper, we consider that the current eligibility threshold is a barrier to the development of competition in the water sector, particularly for retail competition. We believe that a larger market is necessary in order for effective competition to flourish and, even without a change in the Costs Principle, there is some scope for benefit as it will signal market opening enabling businesses to build their business case over a period of time. We see no reason why a lower threshold should make it too difficult to manage supply systems during droughts, as licensees and undertakers will agree how to address drought issues as part of the access arrangements.

### **Question 7: To what level (if any) should the threshold be reduced and why?**

There were 26 respondents to this question in total. Five water undertakers, three licensees and three other stakeholders supported a zero threshold, at least in the long-term. Two business customers and another stakeholder supported an initial reduction to 5Ml/yr, in order to provide a reasonable market size while allowing problems to be solved with minimal customer impact. Another stakeholder pointed out there would be a limit below which the cost of switching would be excessive in comparison with any savings that could be offered, while three water undertakers and Water UK suggested a very low 1Ml/yr threshold to prevent problem cases with

mixed use premises. A few respondents pointed out the merits of using the threshold to limit exposure of customers while the regime is tested. Thresholds of 20MI and 10MI were also suggested by three water undertakers, to avoid costs of expensive customer switching systems. The remaining three respondents argued that the threshold should not be reduced. The following additional points were raised:

- Two water undertakers pointed out that a zero threshold would mean preparing to switch over one million customers which would be significantly more expensive than Scotland's costs for a market of 130,000 customers as it could be difficult to create systems large enough to cope with all of the switching whilst still being efficient enough to create a margin for competition to be effective.
- One water undertaker stated that the threshold needs to reflect the level of cross-subsidy between industrial and domestic customers (if a large number of commercial customers switch, costs to domestic customers may have to increase – and they do not benefit from a choice of supplier).
- The Environment Agency suggested that competition should be extended in one geographical area first before making a change across England and Wales.
- Another water undertaker noted that certainty about future plans is more important than the proposed level, to allow preparation and appropriate investment.
- One water undertaker argued that a quantitative regulatory impact assessment should be undertaken to support any decision on reducing the threshold, and another felt that a cost benefit analysis should be carried out for different types of customers.

### **Our response**

Many of the responses were in favour of a zero threshold, ultimately, and some favoured an interim step. We agree with both of these proposals. See section 3.2 for details.

Amongst the responses, there was some concern about issues that may arise with mixed use premises at a zero threshold. It was felt that at this level it may be difficult to differentiate between business and household customers, for example, where there are flats above shops. If the threshold is reduced to zero we will reconsider the definition of premises to address this issue.

We have considered respondents' concerns about the potential costs and customer impact of a zero threshold, and the need to "test" the market (by using a higher threshold or a pilot scheme in one geographic area). These issues are addressed in chapter five and in question 8 below.

### **Question 8: If you do support a reduction in the threshold, should it be a single or stepped change? Why?**

Of 34 respondents to this question, 3 water undertakers and another stakeholder supported a single threshold change. An approach with at least one step change was preferred by all other respondents. An initial reduction to 20MI was suggested by three respondents, to test the market and ensure systems can cope. 10MI per

year was suggested by others. An initial change from 50MI to 5MI followed by further stepped reduction to 0.1MI was put forward by CCWater. One respondent did not object to a one-step reduction or a series of managed steps, and another two advocated cost-benefit analysis for the various ways of reducing the threshold. Several respondents highlighted the need for a clear timetable set out in advance. The following additional points were raised:

- One water undertaker argued that it is simpler and more cost effective to identify costs and cost drivers for all non-households than to identify those associated with any threshold.
- One business customer stated that a stepped change would pose a burden on licensees obligated to take on additional customers, and the diversity of the market presented by a single change will lower risks associated with market entry.

### **Our response**

We agree with the majority of respondents who supported a stepped approach to a zero threshold, according to a fixed timetable. A low, non-zero threshold would avoid the need for significant investment in customer switching systems at this stage, whilst also allowing more scope for entry and time to address any issues that may arise with a larger market. We will consider further the suggestion of a pilot scheme to roll out competition. However, we would not want progress to be delayed by a smaller market, if a national market was still feasible. See section 3.2 for details.

### **Question 9: Over what timescale do you think the threshold should be reduced? Why?**

The most popular response was for initial change as soon as possible. Some respondents suggested that further changes are only rolled out to more customers after a review period, so timing would depend on the ease of implementation for existing eligible customers. One water undertaker suggested that there should be an option to reduce the threshold further after two years and a business customer proposed the threshold (and capability of associated systems) should be assessed annually. Stepped changes fixed at six monthly intervals were also suggested by another stakeholder. One business customer proposed an initial threshold of 5MI, reduced to 1MI after three years, 0.1MI after five years, and competition open to all after ten years. Another stakeholder preferred a rapid phased approach over a three to six month period. The following additional comments were made.

- One licensee, one water undertaker and two other stakeholders noted that the timescale will be dictated by other necessary changes to framework, as the threshold should not be lowered until a suitable competition framework is in place.
- One water undertaker argued that a quantitative regulatory impact assessment should be undertaken before any decision on reducing the threshold is made.
- Two water undertakers stated that we need to consider how changes will be integrated with the Price Review timetable.
- Several respondents (licensees and water undertakers) said changes should proceed according to a clear timetable to allow new entrants and incumbents to plan and

react. One said the timetable should include timing and criteria to be met for potential additional phased threshold reductions.

### **Our response**

We propose that the initial threshold reduction should be carried out quickly, within a year, (recognising that this is dependent on a change in secondary legislation). The subsequent change to zero, if agreed by Government, should be introduced at a set time in the future to allow sufficient time for the preparation of appropriate infrastructure, including customer switching systems.

### **Question 10: What changes do you think would be needed elsewhere in the WSL regime to make competition work with a lower threshold?**

There were 26 respondents to this question. Twelve respondents (from all stakeholder groups) advocate changes to access pricing / the cost principle alongside a reduction in the threshold for competition to work. Six respondents also said a new system for customer transfer will be required if there is a large reduction in threshold (e.g. below 10MI), and a separate central market authority may be needed to administer the customer transfer protocol. Four respondents called for a national industry-agreed wholesale master agreement and access codes. The remaining four respondents saw the absence of transparency as a barrier, and want visibility of margins by customer size. The following additional points were made.

- One water undertaker commented that Ofwat needs to consider that incumbents currently offer multi-site billing to large users, and the single premises restriction in WSL will cause inefficiency (where the incumbent would bill a licensee for a single large user site and bill the customer directly for the smaller ineligible premise).
- One water undertaker felt that there should be a requirement for retailers to pay for wholesale supplies monthly in advance and another stated that contracts for supply should be longer to ensure payback.
- Another water undertaker said that there needs to be a mechanism to enable customer and retailer to benefit from actions resulting in inefficiencies in water undertakers' operations.
- One water undertaker felt that encouraging greater activity in the market for water abstraction licences would encourage greater competition for combined supply.
- Another water undertaker commented that the additional short-term costs to establish the competition framework should be considered when setting price limits.
- Two water undertakers and CCWater maintained that it is important to ensure ineligible customers are not disadvantaged in terms of cost or service. One of the water undertakers noted that this may occur with higher margins.
- One licensee stated that retail margins may need to be adjusted to reflect net switching costs (i.e. higher margin for smaller volume customers) so that the additional cost, funded by participants, would not negate the benefits gained.
- Another stakeholder felt that there should be vertical disaggregation by function while allowing horizontal aggregation, so that customers benefit from economies of scale and the artificial boundaries of current water undertakers' areas do not constrain production or distribution.

- A business customer stated that more market testing programmes should be initiated, although some issues may not be identified until consumers start switching. A water undertaker noted that Ofwat needs to ensure efficient roll-out of change so that confidence in the regime is not undermined.
- It may not be that “competition isn’t working”, rather that lack of entry may reflect scarcity of opportunities for a licensee to do something more cheaply than the water undertaker. Alternatively there may be non-price barriers to entry which Ofwat needs to investigate.

### **Our response**

Several of the respondents’ points are addressed in other sections of this paper (those concerning changes to the Costs Principle, premises definition/multi site aggregation, competition in abstraction, and transparency of margins).

We are combining proposals to Government for changing the WSL regime with further work that is within Ofwat’s control (such as better cost allocation).

We agree that a centralised switching agency may be necessary for transferring high volumes of customers that would become eligible to switch. It is not yet clear whether a single customer switching authority is more desirable than several similar providers (each in a separate geographic market) operating to the same set of switching rules would be better or worse than a single agency (operating in a national market). However, it is important that a single set of switching rules is used.

We will consider our options and consult further on this issue at a later date as it is important to keep the costs of setting up the market as low as feasibly possible. We will also consider the proposal for vertical unbundling and horizontal aggregation in that paper.

### **3.3 Definition of premises**

**Question 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.**

The majority of the 28 respondents to this question agreed with the proposal, with 18 respondents saying that there is no need to change the current guidance on the extent of premises. Four respondents, including two licensees, thought that Ofwat should revise its guidance on this issue to clarify multi-use premises. The remaining six respondents made no case either for or against a change to current guidance, stating that a change to the threshold requirements would mean that issues such as the definition of premises would become redundant. The following additional points were raised by water undertakers:

- It would be helpful if Ofwat could further define household and non-household premises so that the eligibility of mixed-use premises (e.g. a newsagent with attached dwellings) can be determined.
- If the threshold were eventually reduced to zero for all non-household customers, details of the current definition of premises might need to be reviewed.

## Our response

Having reviewed the responses carefully we do not believe the current guidance on the extent of premises needs to change at this time. However, we acknowledge that should there be a reduction in the eligibility threshold issues may arise regarding mixed use premises. Therefore, depending on the level of the threshold in the future, Ofwat may re-visit the definition of premises if required.

### **Question 12: Do you agree with Ofwat's proposal not to consider multi-site aggregation at this time? Please give reasons for your response.**

Respondents gave a mixed response to this proposal, with most water undertakers agreeing and licensees and business customers disagreeing. The main point raised by water undertakers and one licensee in support of Ofwat's proposal was that if the eligibility threshold was reduced to zero (or close to zero) then the issue of multi-site aggregation would disappear, and so opening up the market prior to any review of the threshold level could have a detrimental impact on the market. Two of the three licensees, all three business customers and two water undertakers were in favour of multi-site aggregation as this would allow for both efficient and effective competition and allow new entrants to compete on a national basis. The following additional points were raised:

- One water undertaker stated that allowing multi-site aggregation would add considerable complexity and confusion to a very uncertain position. A business customer also added that multi-site aggregation should not be allowed until there is experience of how competition works.
- One licensee pointed out that customers have strongly indicated in the recent CCWater/Ofwat survey that this is what they want.
- Another stakeholder added that certain business customers with many branches desire to change supplier to a single supply agreement for all their premises nationally. This is better accommodated by business processes, and physically managed within the metering, billing and similar systems.
- Another licensee noted that water undertakers already offer this service on a regional basis via consolidated billing, so licensees should be allowed to compete and offer a similar or enhanced service on a national basis.
- CCWater felt that multi-site aggregation can have disadvantages in that it encourages discrimination between the same class of customer.

## Our response

We have carefully considered respondents' comments, especially those in favour of multi-site aggregation as a form of promoting effective competition. However, as discussed in the responses to questions six to ten above and as set out in the July paper, we would eventually hope to see the threshold level reduced to zero, and as noted by many respondents this would then take away the issue of multi-site aggregation. Therefore we do not consider it effective to allow multi-site aggregation in the interim, although we do propose that contractual aggregation (in-area trading) should be allowed (see question 13).

### 3.4 Contractual aggregation (in-area trading)

#### **Question 13: Do you believe that in-area trading should be allowed? If not, please explain why and propose an alternative**

The majority of respondents agreed that in-area-trading should be allowed although two respondents said they did not have a strong view, one of which expressed concern about the additional administrative and transaction fees that may arise as a result.

Most respondents emphasised the need for strong regulatory oversight if and when policy is changed to allow in-area trading.

Four respondents (one licensee, one undertaker and two stakeholders) disagreed with the proposal to allow in-area trading, arguing that:

- i) it is too early to promote in-area trading;
- ii) in-area trading would create the potential for 'sloping playing fields'; and
- iii) there is a lack of confidence that associated companies are separate.

Only one respondent proposed an alternative approach (see below) but several respondents reiterated that they believed in-area trading will not be necessary if structural separation takes place.

The following additional comments were made.

- One licensee said that the recent joint CCWater/ Ofwat research suggested that this is something customers would like.
- One water undertaker felt that in-area trading will need to be carried out with arm's-length trading and appropriate cost allocation in accordance with RAG 5 and appointment condition R5 for water companies and standard Licence Condition 7 for new entrants.
- A licensee stated that incumbents' in-area retail arms should be fully separated.
- Another water undertaker noted that in-area trading will become more of an issue if the threshold is reduced (for example national chains, such as supermarkets, could become eligible).
- A business customer suggested that the option described by Ofwat introduces too much complexity and could be better achieved by allowing Water Undertaker A (the incumbent in region A) to supply the premises of Customer X in region A as itself and to supply the premises of Customer X in other regions as an independent licensee in those regions. The rules would allow Water Undertaker A to aggregate its supply to all the premises of Customer X for the purposes of establishing a tariff and providing aggregated billing.

#### **Our response**

In the July paper we noted that with in-area trading, associated licensees could bid for national contracts for eligible customers, thus increasing customer choice and potential margins for licensees. We also stated that for this to occur it would be essential to enforce regulatory requirements for arm's length trading. Most of the respondents have

agreed with this and we therefore will recommend to Government that they change legislation to allow in-area trading by associate licensees within the area of their associated water undertaker. We do not consider that the alternative proposal suggested by a respondent would avoid the need for legislative changes. The safeguards for in-area trading will be strengthened by accounting separation.

**Question 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 customers?**

Ten water undertakers responded, the majority reiterating the need for strong regulation, particularly concerning arm's-length trading plus cost allocation in accordance with RAG 5 and revision of condition R and licence condition 7. One licensee responded, stating that there are already controls in place via existing legislation and licence conditions. Responses were also received from six other stakeholders. The following comments were received.

- One water undertaker argued that in-area trading for single customers should continue to be prohibited but allowed as part of national contracts.
- Another water undertaker felt that in-area trading should be allowed for retail, but they were not sure how this would work for combined.
- One business customer argued that an associate's operation name should bear no relation to the incumbent's.
- One water undertaker suggested that Ofwat should revise guidance on applying for a licence, and as new entrants' businesses develop, associate licensees should be required to have separate directors.
- Another water undertaker also noted that clear guidance will be required on how the requirements of the Competition Act apply to in-area trading.

**Our response**

As explained in our response to question 13 above we consider that in-area trading will require regulatory oversight. In conjunction with any legislative changes agreed by Government, we will amend our guidance to allow in-area trading and ensure that the arm's-length trading between an undertaker and its associated licensee is appropriately enforced.

### **3.5 Licence application fees**

**Question 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.**

The majority of responses to this question came from water undertakers who opposed the proposal to remove licence application fees. One water undertaker did not object to the removal provided it was on a temporary basis, and another stated they did not regard it as a major issue. Other stakeholders expressed mixed views, with three objecting, three agreeing and one expressing concerns about the proposal

being temporary. Four business customers responded, three of whom agreed with the removal of licence fees and one stating that they did not have a strong view but did not consider that a low fee acts as a barrier to entry. Two licensees responded; both agreed with the proposal and one felt it that specific licence application fees constitute a minor barrier to entry. The following additional comments were received.

- One water undertaker felt that the recovery of licence fees will transfer the burden of competition costs to all customers, which contravenes the principle of protecting customers who cannot benefit from it. However, a business customer noted that the removal of application fees would allow an even and level treatment of costs among all participants.
- Another water undertaker argued that using an application fee has the advantage of increasing Ofwat's transparency and accountability – the industry is better able to judge whether the service offers value for money if costs are disaggregated as far as possible.
- CCWater noted that the removal of the application fee on a temporary basis raises the question of fairness to licensees who have already applied and paid this application fee. They also added that until the pricing mechanism produces significant margins we are unlikely to see many new entrants and therefore the removal of the application fee seems irrelevant.
- One water undertaker suggested that it is reasonable to treat licence application fees for new licensees consistently with the way water undertakers were treated at privatisation. However, they noted one key difference; that when undertakers were given their appointments it was known that they would have customers whereas WSL licence applications tend to be more speculative.
- Another water undertaker argued that there is no evidence in the consultation paper to suggest that licensees have not come forward because of fees or that this has inhibited competition.

## **Our response**

In the light of the arguments put forward by respondents we propose to keep to our current approach of charging licence application fees and do not recommend changes. In particular the cost of amending secondary legislation is likely to outweigh any perceived benefits.

## **3.6 Supplier of last resort**

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

Of the 25 respondents to this question only eight agreed that the current regime is effectively a SoLR regime, although a further seven agreed that it is, but for retail only. The main reason for disagreement from the remaining nine respondents was that an incumbent water undertaker may not be able to supply a customer of a combined licensee if they were to fail. The following additional comments were received:

- One licensee, and Water UK commented that returning customers should be treated as a different class of customers because it does not seem consistent to use the same classification as WIA91 sections 52 and 55 for returning customers. Two water undertakers, however, suggested that it would be discriminatory to offer different terms to a returning customer.
- Another licensee agreed that for retail WSL the water undertaker should take back the customer under standard terms, and this should be clearly identified to the customer.
- One water undertaker noted that until the regime is tested and demonstrated to work in a real case, customers will always have some concerns.
- Two other stakeholders and four water undertakers suggested that the strategic supplies legislation needs to be amended to cover combined licensee failure. One noted that it may be appropriate to have similar provisions to the Energy Act, to cover the use of the licensee's network as well as the water.
- A number of respondents noted that the current regime could result in unwelcome and inefficient duplication of resources.
- One water undertaker argued that even the current interim duty is unworkable in practice because it only deals with domestic demand.
- Seven respondents asked for clearer guidance to be issued so that customers are better informed of their current and future security of supply.
- One water undertaker pointed out that there are never any 100% guarantees of supply therefore this should not be an issue for customers of licensees.
- One licensee felt that requirements for combined supply are case specific and it would be sensible for water undertakers to provide more detail on the likely scenarios if the licensee were to fail.

### **Our response**

We agree that the current legislation provides a stronger SoLR regime for retail supplies compared with combined supplies. Customers of combined licensees could not be guaranteed a supply of water by the incumbent water undertaker in the event the licensee were to become insolvent or if the source were to fail, although we maintain that the strategic supply mechanism does provide some aspects of SoLR protection. Nevertheless, we believe that legislation does not need to be amended at this time (beyond that already identified by Government). We will however continue to consider the issue of SoLR and combined licensee failure as the regime develops.

Under WIA91, customers who have switched away are in effect the same as new customers, in requesting a supply under sections 52 and 55 WIA91. We consider it is appropriate for undertakers to offer a standard tariff to both new customers and returning customers. We deal with the issue of clearer guidance with the responses to Question 17 below.

**Question 17: Do you agree with the proposal that water undertakers make their SoLR duties and obligations public? Please give reasons for your response.**

There was a generally positive response to this question, with 17 of the 25 respondents agreeing that SoLR duties and obligations should be made public. However, of these, five felt that it should not be the responsibility of the water undertaker. Four water undertakers felt that Ofwat should publicise the duties in order to protect water undertakers from allegations of scare-mongering and acting anti-competitively. It was said that any contact by the water undertaker with a leaving customer could be seen by a licensee as a predatory action. A further six respondents noted that it is not possible to make these duties public in the case of combined supplies, as each circumstance would be dealt with individually. The remaining respondent believed there needs to be a change in legislation. The following additional comments were made:

- One licensee noted that as there is no distinction in WIA91 between new and returning customers, they do not see how duties can be made public without a change to the existing legislation.
- One water undertaker felt that for combined supply it is not possible to make standard terms and conditions for returning customers and that the implications in these cases should be set out in the access agreement.
- Two water undertakers felt that it should be the licensees who inform the customers of the risks involved in switching.
- Water UK stated that they do not agree that SoLR is a useful concept for informing customers, but that water undertakers should make public their terms for returning retail customers. They also pointed out that terms for a returning common carriage customer are case-specific, and therefore should not be made public.
- Another water undertaker responded that SoLR duties and obligations are public in any event.

### **Our response**

There continues to be uncertainty about undertakers' duties to supply, and customers' rights to a supply. Although we do not propose any further changes to existing legislation (other than those that have already been identified) we feel the current position needs to be clarified. It is for undertakers and Ofwat, in conjunction with CCWater and other stakeholders, to ensure customers understand the competition framework properly and can make informed choices (about switching away from and returning to an undertaker). We do not believe undertakers' agreements with licensees about supplies to individual customers need be a barrier to general statements of intentions by undertakers in how they will treat returning customers, or be barrier to offering default tariffs.

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

There was a mixed response to this question, with fewer than half of the 21 respondents agreeing that increased communication will ease the concerns of customers. Four respondents – three of whom were water undertakers – argued that communication is not needed, as any concerns in this area are not the fundamental reason that competitive activity has not occurred. Six respondents felt

that concerns will still remain about combined supply arrangements and security of supply. The following additional comments were received:

- One licensee and another stakeholder noted that unless new legislation is drafted then raising this issue at this point could actually increase customers' concerns.
- One water undertaker stated that communication may ease customers' concerns but cannot overcome the limitations if the licensee's supply were to fail.
- Two water undertakers argued that extra public information does not improve customers' positions, only understanding, and that reliability and quality of supply are top priorities to customers and they will continue to be concerned about any threat to these requirements.
- Water UK felt that Ofwat should take greater ownership of communication with eligible customers.
- CCWater also felt that it would be helpful for Ofwat to assure customers, in order to allow them to make more informed choices and to more effectively assess risk.
- One water undertaker stated that it should be the customer's responsibility to understand the risks involved and the responsibility of the licensee to explain these risks to the customer.

### **Our response**

Lack of confidence in and understanding of the current regime is an important reason why customers have not yet switched. We believe that clarifying the current regime would be helpful to customers and other parties. We will publish an information note about SoLR in the current regime which will help customers understand their rights. Amending the strategic supplies regime in the manner already identified will also help.

Ensuring customers are fully aware of the water undertakers' duties should enable them to adequately assess the risks involved and make informed choices about switching supplier. We accept that there may always be some residual concerns until the regime is operating smoothly and customers can see that it works.

## **3.7 Competition in providing sewerage services**

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

Of the 26 respondents, 21 agreed in principle to the inclusion of retail competition in sewerage as part of the WSL regime; two other respondents agreed that it could be introduced in the future once the current regime for water has been successfully established. The main reasons given by respondents for the inclusion of retail sewerage competition was the ability for licensees to offer a single bill for water and sewerage to customers and the potential for water undertakers to offer a greater retail margin to licensees. Only three respondents disagreed with this, including two water undertakers and another stakeholder. Their concerns were that retail competition for sewerage would entail costs and is not likely to produce significant

benefits; they also considered that it would be better to concentrate on water resources at this stage. The following additional comments were made:

- One water undertaker stated that the WSL regime currently builds in additional costs by only allowing retail competition for water and another added that currently where companies have a combined retail function for the water and sewerage service, no cost savings can be offered to licensees regardless of customer switches.
- A licensee noted that the ability for a dual service offering could be a factor in a customer's decision to switch, especially if the available margins increase as a result. CCWater added that customers should have the option to choose water and/or sewerage retail services, rather than being tied into having to take both services from a licensee.
- One water undertaker commented that one area that will need to be considered in further detail is the management of trade effluent billing and compliance. The effectiveness of trade effluent compliance management can have a significant impact on the water undertaker's treatment works and discharge performance.
- Another water undertaker argued that retail competition of the type (uniquely) established for the water sector is unlikely to give rise to material benefits, and entails not insignificant costs.

### **Our response**

We propose that retail competition for sewerage should be included as part of the WSL regime. As highlighted by a number of respondents, the inclusion of retail sewerage competition would enable licensees to offer a single bill for water and sewerage to customers. It would also remove the need for water undertakers to bill a licensee's customer for sewerage, allowing them to pass this cost saving on to licensees in the form of higher discounts. We agree with CCWater's comment about choice of retail services. We will consider any potential impacts on the trade effluent regime if Government chooses to include sewerage services in the WSL regime.

We will explore further possibilities for combined sewerage provision, but that at present this does not appear to be workable.

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

There were 25 respondents to this question and more than half of them did not agree that combined competition for the provision of sewerage services should be considered. They highlighted several difficulties and questioned whether there were any benefits to be gained by doing so. The barriers mentioned included the lack of customer benefits and high costs. Although several respondents thought that combined sewerage competition was a possibility there was agreement that a significant amount of work would need to be done before this could happen and some doubt that the benefits that this type of competition could bring would outweigh the costs. A number of respondents noted the fact that on-site effluent treatment already exists as an option and that disposing of waste via tanker is also an alternative. The following additional points were made:

- Two water undertakers and a licensee argued that there is not an effective way of introducing combined sewerage competition without radical restructuring of the industry, which would not be efficient, and there are unlikely to be significant customer benefits. There are also more immediate issues to resolve in the WSL regime.
- One water undertaker pointed out that the characteristics of wastewater vary significantly between customers, especially between domestic customers and trade effluent customers. The cost consequences of having to treat different types of effluent are generally quite significant.
- Another water undertaker noted that the complications associated with such an activity would mean the costs associated with this, and the potential risks to the environment and public health would place significant constraints on any developments in this market.
- Water UK felt that competition could exist if water undertakers operated a 'single-buyer' system through which they commissioned new entrants to build and/or operate waste water treatment works for waste water delivered by the water undertaker's network to the treatment work. That could lead to efficiencies in waste treatment but would not, by itself, provide customers with a choice of supplier.
- Another stakeholder thought that an entrant could provide a private sewer for a single customer or group of customers, which then discharges into a public sewer. If this is a significant proportion of the cost of the sewerage service for those customers, then a commercial offering might be appropriate.
- Another stakeholder felt that there is no reason for inhibiting the development of such a market if the demand exists and if there are entities willing to serve it.
- Another water undertaker stated that it is possible that Ofwat opens up the market and leaves it up to licensees to identify any unforeseen opportunity for competition. To do so, Ofwat needs to clarify customers' risks associated with sewerage competition and ensure that the current regulation effectively communicates these risks.

### **Our response**

At this stage we do not propose to consider WSL competition in the receipt, treatment and disposal of sewage to the public sewer system. There is already a market for the provision of onsite treatment services. The option suggested by Water UK can already exist, in that undertakers have economic incentives to procure and operate treatment works as efficiently as possible.

### **3.8 Inset appointments**

Inset appointments are not considered further in the main paper. The changes to the inset appointment regime are being dealt with as part of the inset appointment guidance which will be published early next year. However for the sake of completeness we have set out a review of the responses we received to the July paper below.

**Question 21: Do you think that the options set out for changes to the inset guidance are sufficient?**

We received many responses to questions 21 and 22 including some very detailed and comprehensive opinions and suggestions. Whilst our review of inset appointments was unanimously welcomed by respondents, some felt that our options for changes to the inset guidance did not go far enough.

Respondents also noted that some of the proposals to the guidance could have far reaching consequences for the industry and would need to be developed in the light of the precedents they may set out for other parts of the water industry. It was also suggested, by several respondents, that Ofwat hold an industry workshop as part of the consultation. The following additional points were made:

- We should propose to Government a legislative change to allow an inset to be revoked.
- Focus should be on new housing developments, as new entrants may be able to offer a range of services including energy and maintenance contracts.
- There could be a licensing system for new entrants wishing to pursue similar opportunities at various sites in different parts of the country.
- Entrants who do not wish to act as retailers could be licensed to act as distributors only with other companies acting as retailers.
- There should be the option of a price review at the instigation either of Ofwat or the appointee.
- The guidance should explain how customers will benefit from inset appointments and give clear guidance on bulk supplies.
- More detail is required as to how Ofwat assesses an inset appointee and Ofwat should share more of its experiences on inset models.
- New insets need some guarantees on revenue expectation.
- A water undertaker's existing customers should not be disadvantaged and face higher charges as a consequence of an inset appointment.
- Guidance should clarify how price limits will be implemented for inset appointees.
- The roles of the DWI, Environment Agency and CCWater should be clarified.
- The inset procedures should be streamlined with as many standard conditions of entry as possible and clear timetables for incumbents to respond to applications.
- Ofwat should treat the initial application by a company as a comprehensive 'gold standard' examination, and Ofwat's procedures should be able to facilitate the level of demand which already exists in the market.
- The lack of success of the current inset regime has damaged the credibility of insets as a mechanism for competition and therefore this area should not be developed further.
- It is important that Ofwat and the industry work together.
- Up-to-date case studies should be included in the consultation and it is important that Ofwat updates its guidance on a regular basis.

### **Our response**

We have considered all of the comments made by respondents and will publish revised inset appointment guidance for consultation in January. We will take forward work on inset appointments separately from this paper.

**Question 22: Prior to the issue of inset appointment guidance consultation are there any other issues that Ofwat should cover in its guidance?**

The majority of respondents included their views on this question within their response to question 21. Additional points raised by six water undertakers and nine customers and other stakeholders are set out below:

- The definition of 'unserved' needs to be covered.
- The variation in bulk supply prices and terms needs to be considered.
- It is inappropriate for developers to be subject to regulatory scrutiny of their competitive proposals.
- Inset appointees should be encouraged to share benefits so that customers experience either lower prices or improved levels of service.
- Ofwat should consider whether insets and WSL regime should continue to co-exist.
- The guidance should explain the availability of self-lay arrangements.
- Ofwat should develop proposals for the protection of customers served by an inset appointment, especially domestic customers in new residential developments.
- Consideration of sustainability issues including grey water systems and sustainable urban drainage systems.

**Our response**

We have considered all of the comments made by respondents and will publish revised inset appointment guidance for consultation early in 2008. We will take forward work on inset appointments separately from this paper.

## **4. Options for longer term change to the water and sewerage industry**

In the following section we will outline the consultation responses to the issues set out in chapter five of the July paper and where possible our way forward. Our detailed proposals for longer term change will be considered in our spring 2008 paper.

### **4.1 Accounting separation**

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

Most respondents supported the greater transparency that accounting separation would bring; it would expose inefficiencies, inform the extent to which competition is likely to be effective, and may highlight previously unidentified markets for other contestable services. Another stakeholder, however, said that accounting separation is not necessary to achieve this transparency. Another respondent warned the scope for effective competition could be *reduced* by additional transparency of low marginal retail costs and lack of value added services that can be delivered.

Respondents acknowledged that consistent cost allocation is not straightforward (especially in small companies where staff and/or departments are shared between functions) and that detailed, unambiguous definitions/guidance will be needed. Water undertakers were concerned that the cost of accounting separation may outweigh the benefits, but other stakeholders thought it is essential for competition to take place. There was general agreement that value will be maximised (and costs minimised) if implementation is consistent with the cost structure of water sector, and allocations and apportionment are minimised.

Six respondents, while recognising the value for companies and customers in understanding their costs, believed mandatory accounting separation is not a driver or facilitator for competition - one of these (a water undertaker) said the type and degree of competition chosen for the sector will determine whether it is appropriate. A seventh believed companies already split their costs in this way (e.g. market testing and adopting outsourcing arrangements), so formal accounting separation would not further aid competition.

Two respondents saw the value of accounting separation only as an evolutionary step towards full structural separation. The following additional points were raised:

- One water undertaker noted that the current degree of cost allocation will vary between companies, and workload for companies could be significant; another added that the level of accounting separation will impact on the cost of I.T. system changes required. A further water undertaker also noted that the complexity and high-level for allocations will mean separation has no impact on competition.
- Another stakeholder commented that accounting separation is inefficient as economies of scale would be lost and so it would only serve to allow entry by inefficient licensees, and a further felt that accounting separation is too susceptible to abuse by the incumbent.
- One water undertaker argued that regional differences make it unlikely that significant conclusions can be drawn - notional margins could be set by applying standard rules to June Return data, to create effective competition within a region.
- Another water undertaker quoted issues with allocation of overheads and consistency between companies, split of CCD and return on assets, and the full definition of retail activities and allocation of overheads required for a notional retail arm.
- Water UK and two water undertakers pointed out the additional regulatory burden and cost implications - the additional workload alongside the 2009 pricing review should be considered.
- One business customer noted that full and transparent understanding of water undertaker costs would improve services and efficiency even among incumbents with no switchers, increase consumer confidence in monopoly companies, and aid demand and cost management exercises that benefit both consumer and supplier.
- Another stakeholder and one water undertaker felt that accounting separation would mean inefficiencies, and areas where cross-subsidies have been applied could be readily identified, which could aid comparative analysis for price controls.
- A licensee and a water undertaker claimed that accounting separation would not be difficult for efficient water undertakers who already fully account for all areas of their business.

- One water undertaker felt that a robust quantitative regulatory impact assessment is needed.

### **Our response**

We propose to take forward our work on accounting separation and cost allocation in January 2008. We will invite participation from water companies and other stakeholders in identifying the appropriate business units to which costs can be allocated, and in designing an appropriate set of guidelines to aid implementation of the new reporting requirements.

### **Question 24: What functions or activities should be accounted for separately and why?**

There were 25 respondents to this question. Four respondents proposed separate accounting only for retail activities. One water undertaker suggested accompanying changes to the regulatory framework to provide an operating margin on retail, and another said that separating retail activities could provide valuable information. Another stakeholder did not support full accounting separation but supports transparent reporting of actual costs allocated between wholesale and retail functions, and another water undertaker claimed separation of abstraction, treatment and network services would be neither efficient nor desirable in terms of drinking water quality, security of supply, and the environment.

Eleven respondents (water undertakers, business customers and other stakeholders) thought accounting separation for discrete activities in the water supply value chain would be appropriate, and gave examples of how the value chain may be split as follows:

- Collection/storage - Production<sup>16</sup> - Distribution - Retail (three respondents).
- Collection & abstraction - Treatment - Distribution - Retail (two respondents).
- Production - Transportation - Supply/retail (three respondents, one of whom proposes secondary separation of Treatment and Abstraction).
- Storage/pumping/distribution - Bulk water purchase and wholesaling - Water treatment - Supply<sup>17</sup> - Debt management (one stakeholder).

Three respondents also expressed opinions on accounting separation for waste water, one of whom sees no value in separating sewerage from sewage treatment. The other respondents suggested separate accounting for:

- Distribution – Treatment.
- Collection - Treatment - Disposal/discharge.
- Distribution/storage/pumping - Bulk sewage discharge - Trade effluent - Sewage disposal - Retail - Debt management.

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<sup>16</sup> i.e. abstraction and treatment

<sup>17</sup> including marketing and billing

The remaining respondents did not specify particular activities, did not agree or offered no opinion. The following other points were raised:

- One water undertaker commented that it would be preferable to undertake separation exercises for all aspects of value chain at the same time, to achieve transparency and understanding while limiting cost and disruption.
- Another water undertaker noted that more analysis is needed of the potential market further up the supply chain before determining which functions should be separated.
- Water UK and two water undertakers further emphasised that accounting separation should be based on cost structures rather than forcing cost allocation to fit an idealised model.
- A business customer thought there is a potential market in network provision, but a licensee said it is important it separate the accounts for the network part of the business which has monopoly characteristics and is likely to need regulating indefinitely.

## 4.2 Structural separation

**Question 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.**

There were 31 responses to this question including 16 from water undertakers. Responses were split evenly between those for and against structural separation, but there was a common preference amongst water undertakers for accounting separation as a more effective option. The following benefits and detriments of structural separation were highlighted.

### Benefits

- Costs are clearly allocated to specific businesses and no residual conflicts of interest occur.
- Structural separation could create more transparency in cost allocation and possibly reduce costs.
- The process should create the conditions to achieve competition for services, including increased efficiency and innovation, and should allow consolidation and separation of distribution.
- It could possibly meet the objective of competition.
- Improved business focus.
- Structurally separating the vertically integrated incumbents along the value chain will give greater confidence to new entrants that they are entering the market on an even footing.

### Detriments

- Unlikely to be efficient in the short or medium term.
- A key difference between water and other regulated industries is the impact on water quality and the environment.

- Structural separation, and subsequent horizontal consolidation, would threaten the existence of the smallest water companies simply through scale effects.
- May produce volatility in the market.
- Structural separation would increase costs and the increase could be significant.
- Reputation of good public service within the industry could be lost.
- Would require changes in legislation.

### 4.3 Household competition

#### **Question 26: Do you consider that there are potential benefits to be gained from household competition?**

Of 27 respondents to this question, 10 believed that retail competition should operate at household level, though most of these conceded there would be serious difficulties in achieving this. Others think it likely that benefits are limited and insufficient to justify the large costs involved. Several respondents said it is premature to consider this before the results of non-household competition are known. The following additional points were raised:

- One water undertaker commented that there is likely to be little demand among customers for competition unless significant cost savings are available, and low retail margins make household competition unattractive. Another added that the current regulatory regime works well for household customers and will continue to do so.
- One water undertaker pointed out that the option to outsource retail functions is already available to companies, so innovation which benefits customers can be achieved in this way with lower risk.
- One water undertaker argued that the greatest potential benefits for competition are in alternative supplies for non-potable water (e.g. grey water recycling), where the cost reduction can be shared between service provider and customer, and customer has choice of price and convenience of service. However, this would have to follow structural separation.
- Another water undertaker considered that there is a question about the capacity for a competitive market to develop where there is a statutory approach to making supplies available and little sanction for non-payment.
- One water undertaker felt that household competition in water is more complex than gas/electricity because no national grid exists and there is significant local variation in cost of supply. Another added that water bills are typically a third of electricity/gas bills so potential benefits for competition are lower.
- One water undertaker noted that customers may suffer high pressure sales, mis-selling and receive a lot of unwanted marketing material, as sometimes happens in energy markets, and the Environment Agency were concerned that retail competition would be confusing to customers, and make communication with customers difficult during drought situations.
- One water undertaker pointed out that a thorough analysis of cost-benefit and risks is needed.
- CCWater, and two water undertakers highlighted the social implications – risks of unwinding of cross subsidies and large bills for some (maybe vulnerable) customers.

Another stakeholder also added that there is a need to ensure public health is not compromised.

- The Environment Agency commented that competition in combined supplies would add complexity to drought management; while customers could in theory choose to pay for different service levels, managing this would be impossible.
- While there is a general feeling that lack of metering could be an obstacle, one stakeholder thought increased metering could also be a beneficial consequence of household competition, if it were a precondition for switching.
- Another stakeholder considered that competition would drive cost savings along the value chain, as in gas and electricity, so it is inappropriate to consider only the small benefits of retail competition. Innovative entrants to the supply market will find financial and service benefits to offer customers.
- Both licensees felt that customer choice would increase significantly, and a water undertaker also noted that it might be possible to extend retail competition into the domestic market where greater savings could be made e.g. single utility billing.
- One stakeholder thought there could be immediate benefits to the consumer and, under the current framework, to the incumbent (by way of the Costs Principle).

#### **Question 27: Should household competition be considered in parallel with greater metering?**

Most respondents (nine water undertakers, five stakeholders, three customers) thought metering would have to be a pre-condition of switching. Some others (one water undertaker, two licensees and another stakeholder) believe properties would not necessarily need to be metered, as the retail cost of billing could be identified for unmeasured customers – consumer profiling was suggested for this. There is support for greater metering with or without competition. The following additional comments were made:

- One water undertaker said that a lack of metering could also be a problem for non-households if the eligibility threshold was reduced to zero.
- A stakeholder argued that as household competition would take some time to implement, and companies are indicating they are looking at greater meter penetration in the longer term, there is no reason why the current low level of metering should be a barrier to household competition.
- One water undertaker noted that fixed price offers could still be made to metered households by new entrants.
- Another stakeholder considered that further metering would allow favourable ‘off-peak’ tariffs to be offered, and smart meters could be used to control throughput on certain tariffs. It would be possible to read water meters in conjunction with electricity/gas meters for greater cost efficiency.

## **4.4 Competition in the “production” of water**

#### **Question 28: Do you agree with our assessment of the opportunities for competition in this area?**

Respondents gave a mixed response to this question. Of the 26 responses received (including 14 from water undertakers), 13 agreed with Ofwat's assessment and 11

disagreed, with two respondents having no particular view on this issue. Supporters asserted that there is significant scope for the creation of competition in the production of water and that creating further markets within the industry could offer greater scope for benefits. One stakeholder stated that production competition will provide great benefit to both domestic and commercial customers. However economic constraints have not allowed benefits to materialise so far, and are likely to preclude this for the foreseeable future. Several water undertakers opposed the idea of releasing water resources as they are unclear how they could then meet their supply obligations in fulfilling statutory Water Resource Management Plans. The following additional comments were received:

- One water undertaker argued that Ofwat's assessment describes possibilities but is highly theoretical and fails to address practicalities.
- One water undertaker felt that a major restriction to effective competition in this area is the Environment Agency's power to refuse licensing resources that it considers are not sustainable. This effectively gives them the ultimate choice of where water resources are developed. In their own response however, the Environment Agency noted that it is important to remember that there is value in leaving water in the environment and for other water users.
- One water undertaker felt that as long as vertically integrated business exists, there are no pressures to respond to these opportunities. Another added that a major stumbling block is and will be the cost of access to the distribution mains.
- A business customer commented that the idea of a water release programme as a method for enhancing competition in this area is supported and it was used to great effect in the competitive UK gas market. However, a water undertaker argued that the gas release programme is not an appropriate analogy for the water industry, and another stakeholder said that it is not clear what a water release programme would comprise.

**Question 29: Do you consider there are any other factors that we need to take account of?**

There were 14 respondents to this question including 9 water undertakers and 2 licensees. Other factors that respondents thought Ofwat should take account of included drinking water safety plans; climate change; drought plans; water resource plans (and catchment abstraction management strategies); and water trading. The following additional points were raised:

- One water undertaker commented that divestment of water abstraction rights would lead to a creation of smaller local monopolies, similar to the pre-1974 structure. This would not promote meaningful competition.
- A licensee and one water undertaker felt that the case for a water release programme should be considered as a means of stimulating competition and it may provide opportunities for access by licensees to water produced by an incumbent in an unbundled market.
- However, two other water undertakers argued many points against water release programmes such as, the intrinsic link between the release of water resources and the water undertakers' ability to meet supply obligations, and the fact that the release

of water could result in the reassessment of licences and potentially a reduction in deployable output.

- One water undertaker also argued that circumstances surrounding the gas release programme are very different to water. In particular, that the gas programme occurred at a time when increased amounts of gas became available.
- Another stakeholder added to this saying that it is a mistake to rely so heavily on experience in other utilities and to assume water must follow their example.

**Question 30: Do you have any other suggestions for developing competition in this area?**

There were ten respondents to this question including four water undertakers and one business customer. Water UK stated that they are currently commissioning work to review alternative forms of competition. The following comments were made:

- All water companies have duties to maintain the supply-demand balance. There is also a need to maintain an agreed amount of headroom. Within these economic constraints it is unlikely a water undertaker would either be able or willing to release resources.
- Many large industrial users have opportunities to recycle water or to re-use recycled water from other sources. In the right circumstances this is much better for the environment in sustainability terms.
- Resources owned by water undertakers should remain in their ownership provided they have a demonstrable need for those resources. However, where the need is not demonstrated they should be made available to others.
- Introducing a nationwide distribution company would do more to release water supplies to areas of low net surplus than the current system.

## **4.5 Competition in abstraction**

**Question 31: Do you agree with our assessment of the water rights trading regime? Please give reasons for your response.**

There were 22 respondents to this question, half of which disagreed with our current assessment of the regime. Seven respondents agreed with our assessment, and a further two agreed although they felt that the regime is not operating as such in practice. A total of 14 water undertakers responded, and eight of those did not agree with our assessment. There were a number of reasons for disagreement, outlined below.

- The Environment Agency and two water undertakers noted that the regime is actually much more complicated than described. For example, the distance over which licences can be traded is a key issue, and it is only necessary to trade water rights where water is already scarce.
- Two water undertakers and another stakeholder argued that many abstractors may retain any unused capacity because it gives them flexibility, and in addition to this abstractors may feel that if they relinquish some of their entitlement the Environment Agency may withdraw it.

- Another stakeholder and three water undertakers stated that they do not believe the Environment Agency is committed to rights trading, nor have they encouraged it.
- Two water undertakers argued that the Environment Agency does not have a duty to promote competition, but a duty to protect the environment, which is not compatible with competition.
- Another stakeholder noted that water undertakers will not be encouraged or incentivised to trade rights if this results in them losing market share in downstream activity.

**Question 32: Please consider how Ofwat and the Environment Agency can increase awareness of the abstraction trading regime?**

There were 19 responses to this question, with four main suggestions being made. Six respondents felt that there needs to be greater publicity of the regime in general; five respondents felt that there needs to be some form of database or register of information relating to abstraction licences and water availability, four argued that it is the job of the Environment Agency to increase awareness, not Ofwat; and the final four felt that there is no need to increase awareness as this is not what has led to a lack of activity. The following additional comments were received:

- Three water undertakers stated that the Environment Agency does not make information about the use of water from existing sources easily available to the public and that there needs to be some form of public register, or database where they should publish details of when licences are surrendered.
- Two customers, another stakeholder and three water undertakers requested that Ofwat and the Environment Agency publish a more general information note to enhance consumer understanding of the regime.
- One water undertaker felt that there is limited scope for abstraction trading due to environmental protection.
- Another stakeholder argued that neither Ofwat nor the Environment Agency will be in a position to say whether any part of a licensed entitlement is “spare”.
- Another water undertaker stated that the current lack of trading is not due to lack of awareness of the regime.
- The Environment Agency argued that information on abstraction trading is readily available on their website and that public registers provide information about existing abstractors with whom trades could be made.

**Question 33: Please consider how Ofwat and the Environment Agency could further facilitate water rights trading? Do you agree with our proposals for changing this? What other suggestions would you make?**

There were a number of different suggestions made by the 16 respondents to this question. The most popular answer (four respondents) was that Ofwat and the Environment Agency need to work together to reduce the procedural burden of applying to vary terms and conditions of a licence. Three respondents argued that greater publicity will facilitate the regime and another three respondents felt that the regime could not/does not need to be facilitated further. The following more detailed suggestions were made:

- Two water undertakers felt that there needs to be greater reform of the process, by placing an “economic” value on water and creating a market place in which to trade the water rights.
- One licensee stated that in order to encourage abstractors to trade unused rights, there needs to be greater focus on demand management measures.
- One water undertaker noted that as part of any review of abstraction licence trading, Ofwat and the Environment Agency need to consider un-used entitlement held by other abstractors such as industrial companies and agriculture.
- Another stakeholder and one water undertaker argued that there needs to be greater assessment of the risks involved in trading of abstraction licences.
- CCWater felt that it is not clear whether the amendments made during the Water Act Process were done with competition in mind.
- Another stakeholder noted that “new” water is readily available in some areas of England and Wales, yet applications for combined supply have not materialised. This suggests that the current limitations on trading are not necessarily the most important barrier.
- Another stakeholder felt that unbundling is essential to promote competition in abstraction.

**Question 34: Are there any other strategies that Ofwat could pursue to assist with the facilitation of combined supplies under the WSL regime?**

There were only 13 responses to this question, with many respondents feeling that they had nothing to add to the previous question. Four respondents argued that we should fully establish retail competition before concentrating our efforts on combined supply. Three respondents re-iterated the need for greater public information about water availability and two respondents again mentioned the need for a market place and an economic “value” of water. The following additional comments were received:

- One water undertaker noted that Ofwat can ensure that the incentives offered by the competition framework are appropriate to promote effective competition, and then the organisations in the industry should be empowered to take advantage of opportunities as they arise.
- Another stakeholder believed that the Environment Agency should promote other major projects, such as conjunctive use, as water undertakers cannot independently countenance these types of projects.
- Another water undertaker argued that currently licensees are focussing their criticism on the failure of the regime to deliver viable propositions for retailing water to their customers and are showing little enthusiasm for competing in abstraction or other stages of the supply chain.

**Question 35: What other steps could Ofwat take to increase competition in abstraction?**

We received only three responses to this question as many respondents felt that the previous two questions discussed all of the available options to increase competition. The Environment Agency noted that there are a number of abstraction licences that are already held by new entrants interested in competition, yet few of these have

made use of this water, therefore other barriers must be preventing competitive activity.

Another suggestion was that accounting separation would be the single most effective step to increasing competition. One respondent to the previous question also suggested separation of water services was vital to competition.

Finally, one stakeholder argued that the long term risks to customers need to be addressed. Licensees need long term contracts to secure the recovery of their up-front capital investment, yet customers will not be committed to a very long term contract if risks are not addressed. The main risk argued is that of combined licensee failure, and the solution suggested is to amend the strategic supply designation legislation.

### **Our response**

We will work with the Environment Agency to improve our understanding of the existing licence trading regime, look at how we can collaborate to promote water rights trading and explore the potential for greater competition in trading.

Competition and trading in abstraction rights have a potentially important part to play in the delivery of the Environment Agency's duty to manage water resources and Ofwat's duty to consumers. The Environment Agency is keen to work with Ofwat to identify the potential benefits and costs of competition in abstraction.

## **List of respondents to the consultation on market competition in the water and sewerage industries in England and Wales**

Aquavitae Ltd  
Satec Ltd  
Severn Trent Select Ltd

### **Water undertakers**

Anglian Water  
Bournemouth & West Hampshire Water  
Bristol Water  
Dee Valley Water  
Mid Kent Water  
Northumbrian Water  
Portsmouth Water  
Severn Trent Water  
South East Water  
Southern Water  
South Staffs Water  
South West Water  
Thames Water  
Three Valleys Water  
United Utilities Water  
Welsh Water  
Wessex Water  
Yorkshire Water

### **Customers**

Chartered Institute of Purchasing and Supply  
Chemical Industries Association  
Energy Information Centre  
Gemserv  
Home Builders Federation  
Major Energy Users Council Limited

### **Other Stakeholders**

Alan Bland (Independent consultant)  
CCWater  
Environment Agency  
Gas Transportation Company Limited  
Independent Water Networks Limited  
LogicaCMG  
Royal Society of Chemistry  
Water UK

## Annex Two - Indicative Access Prices 2007

At the end of October 2007 water undertakers submitted their revised indicative access prices for 2007. These illustrate the differences between retail and combined supplies. A retail supply takes place when a licensee purchases a wholesale supply from a water undertaker and sells it to an eligible customer. A combined supply takes place when a licensee introduces its own water into a water undertaker's network to supply an eligible customer.

- **Retail indicative prices**

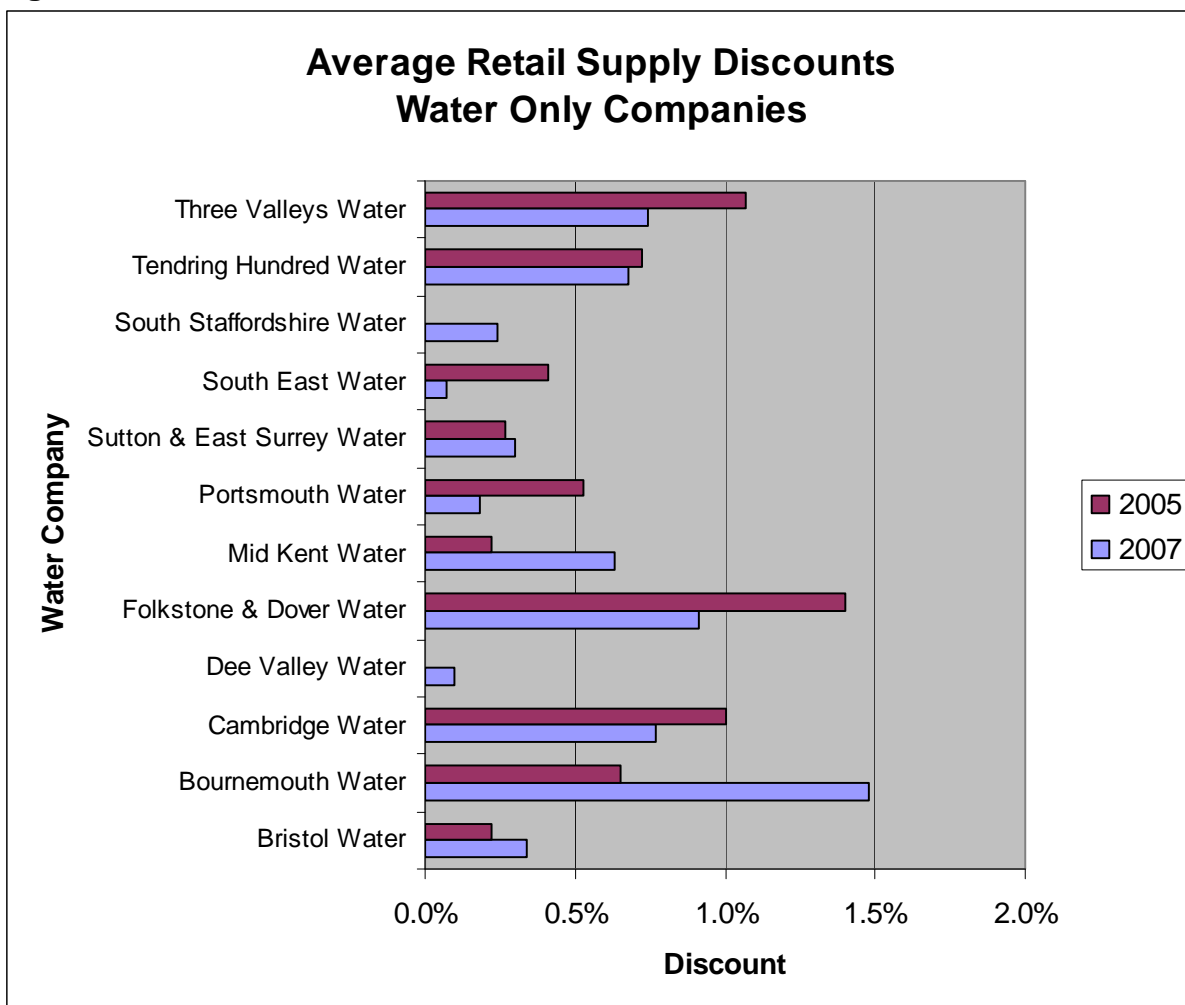
For 2007, access prices offered by undertakers to licensees offering a retail supply to customers are generally in the region of 0%-2% (this percentage represents the discount from the normal cost of supplying water to a customer). The margins for retail supply remain very low, with the maximum discount offered in 2007 of 3.74%. This is a small increase over the maximum discount of 2.5% indicated in 2005.

Figures 1 and 2 show the indicative retail discounts submitted by companies in 2007 compared with 2005.

**Figure 1**



Figure 2



• **Combined indicative prices**

For combined supply, the 2007 discounts were generally in the range of 3% to 20%, whereas in 2005 the discount levels were somewhat lower, lying between 0% and 10%.

We issued undertakers with a revised access code guidance on 31 July 2007, in which we set additional guidelines for the provision of indicative access price information. Water undertakers were requested to:

- calculate indicative wholesale discounts for a second customer with the same licensee, at both the 50MI and 500MI pa consumption levels;
- provide more detailed retail cost information split according to different classes and size of customer;
- calculate indicative access prices and ARROW costs without including any costs that may arise in the provision of services under s63AC (WIA91 interim duty of supply);

- provide additional information about the level of water input that is necessary to trigger deferment of planned expenditure on water resources by one year. That should include any planned capital schemes and should relate to the water undertaker's indicative combined supply prices.

In Figures 3 and 4, the average combined supply discounts are given, for water and sewerage companies and water only companies respectively, based on indicative access price information supplied by the water undertakers in 2007 and 2005.

For each water undertaker, the average has been taken across all resource zones and years from 2007-08 to 2011-12<sup>18</sup>.

Between 2005 and 2007, there has been an increase in the average combined supply discounts being offered by Anglian, Northumbrian, Severn Trent, South East and Yorkshire. The discounts for Bristol, Bournemouth, Cambridge, Folkestone, Portsmouth, Sutton and East Surrey, Southern, South Staffs, Thames, Tendring Hundred, Three Valleys, Welsh, Wessex and United Utilities have remained at around the same levels. There have been reductions in the discounts being offered by both South West and Mid Kent.

The largest average combined discounts for 2007 are offered by Anglian, Northumbrian, South East and Severn Trent and are all in excess of 10%. Northumbrian's discounts were the largest in 2005 at around 20% and have now increased to around 30%. The average discounts for the other three water undertakers are at least three times their 2005 level. The following undertakers have the lowest average combined discounts: Bristol, Bournemouth, Cambridge, Portsmouth, Three Valleys, Wessex and United Utilities. All have average discounts of less than 5%. In some cases the discounts quoted have increased for 2007, but not by more than 1% for any company.

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<sup>18</sup> The level of detail in the prices has increased from the 2005 basis, and a simple average is used to make this summary presentation clearer and concise.

Figure 3

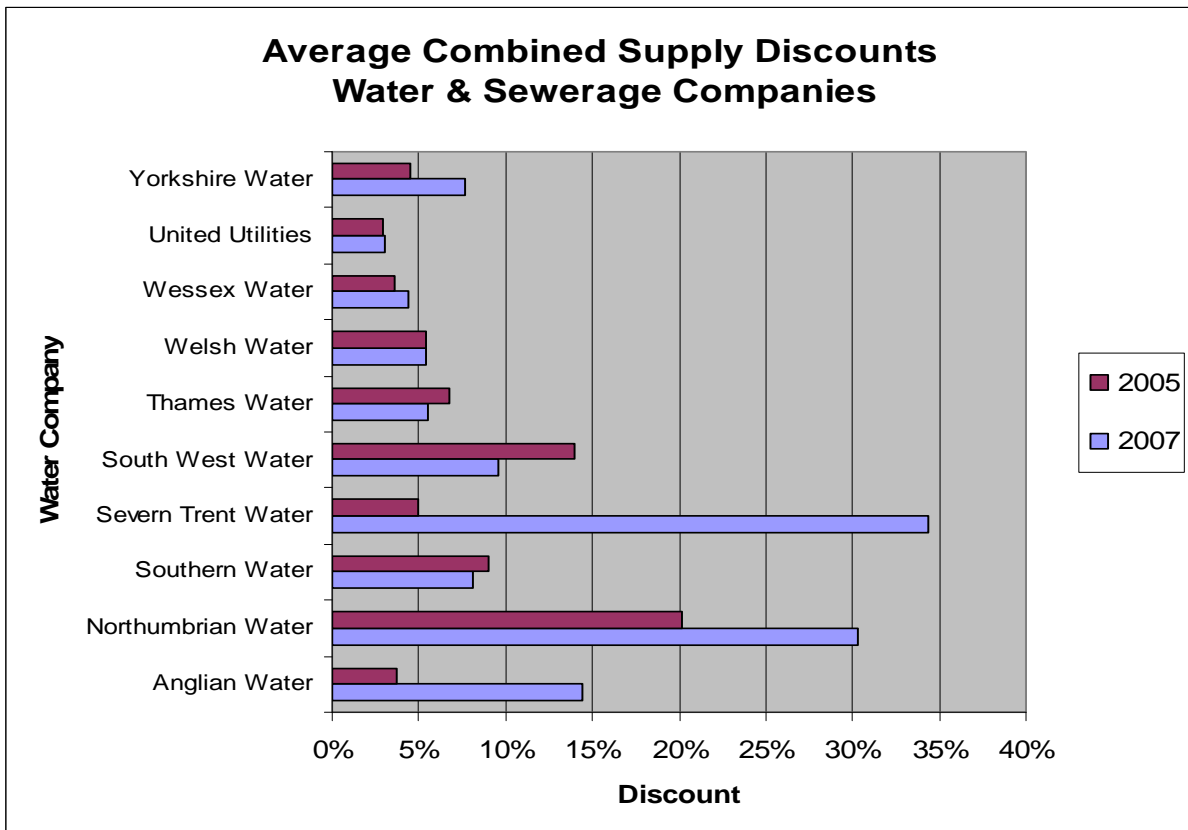
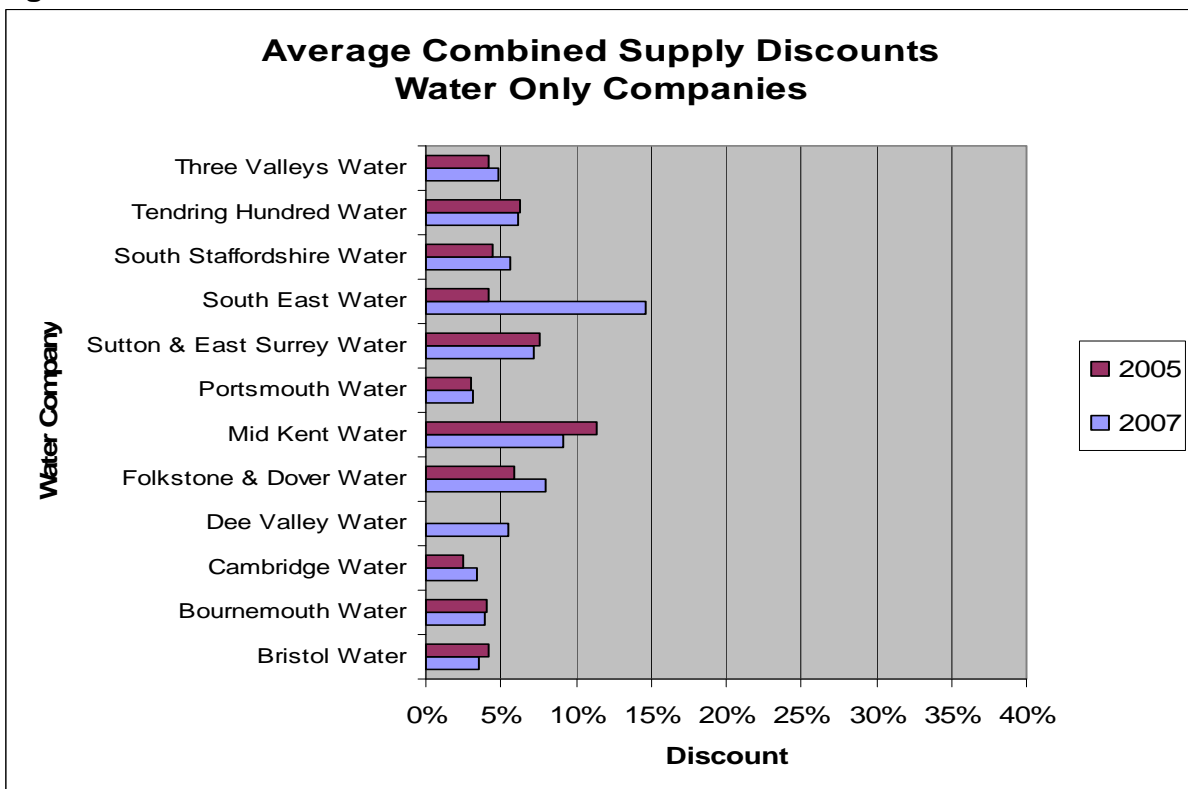


Figure 4



In 2007, there are 36 resource zones where discounts being offered were greater than 10%, for at least 1 year, of which 24 zones are offering this level of discount over the full 5 year period. Discounts greater than 20% are being offered, for at least 1 year, in 15 resource zones, with discounts greater than 30% being offered in 11 resource zones, greater than 50% in 7 resource zones and greater than 100% in 2 resource zones.



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