

A level playing field for the water market – a discussion document

About this document

The UK Government's [Water Bill](#) was introduced into Parliament and published on 27 June 2013. It is designed to address the current and future challenges faced by the water sector, which were described in the [Water White Paper](#). Among other things, it is designed to:

- increase customer choice;
- improve service provision;
- stimulate innovation; and
- drive more sustainable approaches to managing our scarce resources.

The Welsh Government has adopted a different policy position in this respect and the issues discussed in this document will therefore be less relevant to companies wholly or mainly in Wales.

Given the UK Government's proposed reforms, we need to carry out prudent preparatory work ahead of the Bill being enacted. As part of this, we need to review the current measures that we have for ensuring a level playing field to support the new choice and trading arrangements.

Initiating a review of the options for securing a level playing field now will enable any required changes to be captured within the arrangements that the UK, Scottish and Welsh Governments, Ofwat, the Water Industry Commission for Scotland (WICS), the industry and customers are developing under the [Open Water](#) programme.

This document:

- considers some of the potential tools currently in place to provide for a level playing field;
- outlines tools that could be used to strengthen this framework, drawing on experiences from other network industries; and
- sets out our proposed approach to the phased removal of the 'in-area trading ban' licence condition.

We have discussed the content of this document with Open Water and the High Level Group, and we invite views on the questions and issues we have set out within it. Those views will inform our thinking as we help to implement the proposed changes.

We have also published a separate discussion document on [governance arrangements for market codes](#), which is intended to be read alongside this one, and we invite responses to both. The governance arrangements for market codes (that is, the rules about how the content of the codes will be decided and the process for agreeing changes to those codes) will play a key role in helping ensure that there is a level playing field.

There are two aspects of discrimination: ‘non-price’ and ‘price’. We need to ensure that both are addressed effectively to deliver a level playing field. In seeking to address the second, charges and charging rules will play a key role. This document does not consider charging-related issues in any substantive detail – instead, it focuses more on ‘non-price’ issues.

Please note: this discussion document is not part of Ofwat’s price review process, and so it does not fetter or pre-empt in any way our discretion and policy decisions relating to the 2014 price review. Details of our price review can be found in our [methodology](#), and other documents that are clearly linked to it (such as the final determinations in due course). For the avoidance of doubt, if there is any inconsistency between this discussion document and our price review documents, for the purposes of the price review the price review documents would take precedence over this document.

Correction

The last paragraph on page 5 was updated on 27 September 2013.

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Key messages

- Delivering choice for business customers, driving efficient use of precious and scarce water resources and promoting increased resilience are at the heart of the reforms the UK Government has proposed for the water sector.
- The UK Government expects the changes to deliver benefits of £2 billion to the economy over the next 30 years. These benefits will be delivered through a combination of customer choice and efficient market entry, which will:
 - create a more vibrant and open sector;
 - bring new ways of working;
 - improve customer service; and
 - help keep the cost of customers' bills down.
- Experience in other sectors shows that, for these benefits to be realised, it is essential that there is a level playing field between companies already in the market ('appointed companies') and those entering the market ('new entrants'). A level playing field is required if market entry is to be viable and attractive to new entrants, and will also protect against the risk of anti-competitive behaviours that could reduce the delivery of benefits to customers and the economy.
- This is particularly important where there is a single network, or several networks, within geographically defined area(s), that are essential to deliver goods and services to customers (as there are in energy, fixed telecommunications and water, for example). Where there are appointed monopoly companies delivering services at all stages of the value chain – as is the case in water – ensuring a level playing field is essential.
- Experience shows us that, without a level playing field, there is a real opportunity for appointed companies to discriminate in favour of their own services and customers, disadvantaging new entrants. This may lead to higher costs to customers and ultimately could put at risk the benefits from increased choice and effective competition.
- There are existing regulatory tools that we can use to prevent this happening. These tools fall into two categories:

- **ex post tools**, which are used to remedy the impact of anti-competitive behaviour after it has been identified; and
 - **ex ante tools**, which are implemented within a market to prescribe required actions and so prevent anti-competitive behaviour before it occurs.
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- In the light of the reforms in the Water Bill, we are considering the importance of a level playing field, the tools Ofwat has to deliver that and how we should use those tools. As we look at this issue, we are mindful of the changes made by the Government to the UK competition framework – in particular, the changes in the new Enterprise and Regulatory Reform Act 2013 (ERRA13) which require Ofwat, together with other sectoral regulators, to consider whether the use of powers under the Competition Act 1998 (CA98) are appropriate before taking any enforcement action or imposing a penalty under sectoral powers.
 - The ERRA13 has also repealed the relevant legislation relating to the condition in **water supply licensees**¹ licences to ban in-area trading. We propose to remove the in-area ban for each appointed company's 'arm's length' retail water supply licensee once those appointed companies have established (but not necessarily implemented) a set of requirements that will deliver a level playing field for a non-household retail market in their appointed areas. If this exercise does not allow for a sensible set of remedies to be established that can be implemented across the sector, then we will consult on the removal of the in-area trading ban for all water supply licensee entrants by April 2015 at the start of the next price control period.

¹ This text was updated on 27 September 2013.

Questions for discussion

We welcome comments on any of the issues covered in this document, but in particular, we are interested in your responses to the following questions.

Q1 Do you consider that further regulation, beyond that provided by existing tools, is required to ensure a level playing field?

Q2 If so, what form do you think such regulation should take?

Q3 How might we measure the effectiveness of the arrangements?

Q4 How do you think the arrangements might evolve over time?

1. Introduction

1.1 Harnessing market forces

The UK Government is proposing changes to the legislative framework for the water sector in England. These changes, set out in the Water Bill, will harness market forces to enable:

- all non-household customers in England to choose their water and sewerage service supplier; and
- the wholesale trading of water between appointed companies and new entrants, promoting the efficient use of our scarce water resources and improvements in the resilience of services for customers.

All non-household customers in England will be able to choose whom they buy their water and sewerage services from. This means that existing and new companies will have to compete with each other. They will have to find out what their customers want in terms of price and service, and strive to deliver the best deal to keep or win their custom. Customers will be able to benefit from:

- improved service provision;
- efficiency savings (including through reducing their consumption and using water more wisely); and
- reduced administration costs (such as by a multi-site customer being able to appoint a single supplier for all its sites).

In the wholesale trading arrangements, water companies will be more easily able to buy and sell water to each other. The proposed reforms will also increase competition and encourage new entrants who can offer alternative sources of water or innovative ways of treating wastewater. These changes will promote efficiency in the use of our scarce water resources and improve the resilience of services for customers.

The overall benefits to customers will be achieved through a combination of customer choice and market entry, which will:

- create a more vibrant and open water sector;
- bring new ways of working;

- improve customer service; and
- help keep the cost of customers' bills down.

1.2 What changes will be introduced?

The Water Bill proposes several changes to the water sector. In particular, it proposes to introduce a series of new authorisations to the water supply licensing framework. These authorisations would allow parties to provide services in a number of areas that were previously monopolies or where only limited choice was available. Licensees would be able to:

- input water into the networks of the appointed companies (referred to in the Water Bill as a '**wholesale authorisation**') as long as that water is associated with an onward sale to customers through a retail authorisation (see below);
- take water from the networks of the appointed companies (referred to in the Water Bill as a '**retail authorisation**') for onward sale to their non-household customers; and
- perform equivalent services for these authorisations in the sewerage sector, and take wastewater and (or) sludge from a sewerage network for purposes of recycling or energy production, for example (referred to in the Water Bill as a '**disposal authorisation**').

Appointed companies would still be able to provide the services that they do today. And they would retain their monopoly to provide a retail service to household customers. They would also be required to interact with – and provide services to – licensees in relation to each of the new authorisations. If an appointed company wished to offer wholesale, retail, or disposal services outside of its appointed area, it would need to establish a separate company, apply for a licence and be subject to the same regulations as all other licensees. In effect, it would be a 'new entrant' within these areas of the market.

1.3 How do we make sure the benefits are realised?

Experience from elsewhere in the economy shows that a level playing field must exist between all companies to avoid the risk of anti-competitive behaviours that could endanger the benefits that can be achieved through choice and market entry.

Such a level playing field will provide all parties with an equal opportunity to provide services to customers.

A number of tools already exist to provide a level playing field. But, given the reforms in the Water Bill, we need to consider whether the current measures will be sufficient to ensure a level playing field in the future.

1.4 Why consider this now?

In July 2012, Defra announced that a realistic target date for the retail market to open for all non-household customers was April 2017. This continues to be the target date following the publication of the Water Bill. The prudent preparatory work to design, implement and test the market arrangements has begun through the Open Water programme ('Open Water'), and we understand that some companies have also begun to consider the changes they need to make to bring about their introduction.

In June 2013, Open Water published ['The New Retail Market for Water and Sewerage Services'](#), which puts forward a range of issues for discussion.

Responses to this document and the one we are publishing alongside it on governance for market codes will help us contribute to Open Water's work.

Also, the recent removal in the ERRA13 of the relevant legislation relating to the in-area trading ban means that we are able to take away those restrictions on water supply licensees. While this will help to ensure a level playing field, other measures may be required to help as there will be a greater risk of undue discrimination.

2. Defining a level playing field

2.1 What is it and why does it matter?

A level playing field gives all companies an equal opportunity to provide services to customers. In this context, 'customers' includes all those that participate in a market. For example, a retailer that buys a supply of water from a wholesaler is a customer of that wholesaler.

A market with a level playing field does not permit the giving of undue preference to, or undue discrimination against, one party compared with other parties. This means, for example:

- a vertically integrated company offering the same network service and terms to entrants with a wholesale authorisation as it offers to its own wholesale operation;
- companies with significant market power not abusing that power to disadvantage other companies as compared to their own organisations; and
- customers being free to switch supplier without their retailer 'blocking' the switch.

A level playing field does not mean that all competitors will succeed equally – this is determined by how good they are at operating in the market. But it does mean that all parties play by the same set of rules. Success or failure is then a matter of their ability to meet customer requirements and to do so better and more efficiently than their competitors.

In the absence of a level playing field, the company that is able to provide the best and most efficient solution for a customer may be prevented from doing so. This may be evidenced by, for example:

- companies being unable to enter the market as a result of undue preference or advantage being afforded to existing market players; or
- companies being prevented from offering services to customers by the actions of other companies.

Establishing a level playing field is necessary in order to bring about and encourage market entry by new participants. It also minimises the risk of companies engaging in anti-competitive behaviours that may otherwise result in customers paying higher prices or receiving lower-quality services.

2.2 Why is this important for the water sector?

The appointed companies currently own and operate:

- the transportation and distribution networks;
- storage facilities; and
- treatment plants.

They are also the main providers of wholesale and retail water and sewerage services to customers – although the extent to which these services are integrated, outsourced or provided by a separate legal entity varies across the sector.

For new entrants that want to compete with the appointed companies, access to wholesale services is essential to enable them to provide water and sewerage services to their customers.

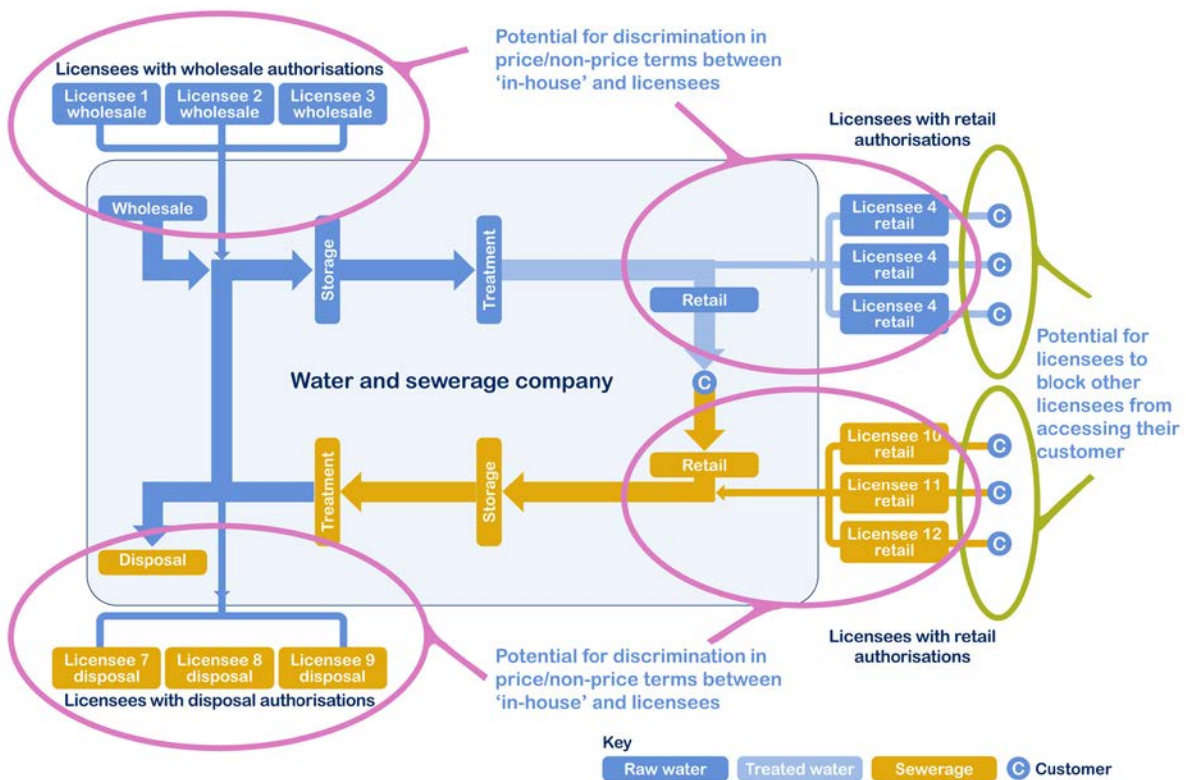
Figure 1 below illustrates this and shows where other companies may seek to provide services to customers. For market forces to be harnessed we will need to make sure that all competitors are treated in the same way as the appointed companies' in-house service providers – or rather that their in-house service providers are treated in the same way as new entrants.

Figure 1 also shows where there could be discrimination between in-house service providers and other companies. For example, a level playing field would ensure that the in-house disposal arm of an appointed company is not offered preferential terms by its 'owning' company compared with another disposal service provider. Both disposal organisations would:

- be subject to the same charging framework for transportation services provided by the appointed company;
- pay the same prices for equivalent services;
- be provided with the same level of network information within the same timescales; and
- receive the same level of service.

In this way, the two disposal organisations get the same non-price and price services from the appointed company for the same service requirements. As a result, both organisations have an equal opportunity to offer services and the customer can choose the one that best meets its needs. In the water sector in England, many of the current water supply licensing entrants are also associated with the existing appointed companies but operate at arm's length. So there is also a risk that the appointed companies favour their own arm's length entrant over another. To address this risk, in the Water Act 2003 the UK Government established the in-area trading ban, which prohibits entrants from trading within the area of their associated appointed company.

Figure 1 Illustration of alternative service provision and some potential areas of anti-competitive behaviour



As well as making sure that appointed companies do not unduly discriminate against water supply licensees, it is equally important to make sure that licensees do not behave anti-competitively. For example, a licensee should not be able to exploit its position as the existing retail service provider to a customer by blocking another company from accessing that customer.

Measures to promote a level playing field will have benefits. But there will also be some administration costs for market participants, which may impact on the way they operate their businesses. Level playing field arrangements should be as effective as possible, while taking account of the potential costs and impact on those in the market. If these arrangements are effective, they should also help avoid costs and delays that might otherwise occur during market development.

2.3 How might an un-level playing field manifest itself?

Experience in liberalised markets shows that an un-level playing field can manifest itself in a number of different ways – examples include:

- abuse of market power (non-price);
- abuse of market power (price); and
- information misuse.

We consider each of these in more detail below.

2.3.1 Abuse of market power (non-price)

This occurs when a company with market power uses exclusionary or predatory behaviours to influence market outcomes, with the aim of eliminating or restricting the services that competitors can provide. Examples of non-price abuse include:

- **refusal to deal** – for example, refusing to make an essential service available to other companies without objective justification, or offering access to this service only on unreasonable terms: in the water sector this could be the water itself or the transportation network; and
- **non-price predation** – where the quality of a service is varied depending on who is receiving it: for example, a company offering a higher standard of service to customers of a certain company or group of companies.

The case study below sets out an example of a refusal to deal – that is, where a firm attempts to prevent companies from entering the market or, in this particular case, seeks to eliminate an existing participant by refusing to provide access to an essential product or facility.

Case study – refusal to deal: Commercial Solvents

The case against Commercial Solvents was the first to be determined as a refusal to supply under what is now Article 102 of the Treaty on the Functioning of the European Union (TFEU). Commercial Solvents was the dominant supplier of a chemical used in the pharmaceutical industry. The company decided to expand its operations beyond providing the raw materials and entered the market for the finished product. A company that operated in the retail market for the finished product and that had previously purchased supplies of the chemical from Commercial Solvents was refused further supplies and complained to the European Commission. The Commission found that Commercial Solvents had abused its dominant position, ordered it to resume supplies to the customer, and imposed a fine.

Following an appeal to the European Court of Justice (ECJ), the court upheld the European Commission's decision and concluded that:

“an undertaking which has a dominant position in the market in raw materials and which, with the object of reserving such raw material for manufacturing its own derivatives, refuses to supply a customer, which is itself a manufacturer of these derivatives, and therefore risks eliminating all competition on the part of this customer, is abusing its dominant position”.

The ECJ found that, by refusing to supply the company, Commercial Solvents had abused its dominant position.

2.3.2 Abuse of market power – price

A common example of price abuse in a vertically integrated sector is a ‘margin squeeze’. A company exerting a vertical margin squeeze discriminates in favour of its own (or related) downstream business and those of other companies. A margin squeeze occurs when the margin between the price the integrated company charges for the essential input it controls and the price a rival could achieve for the downstream product (or service) is too small to allow the efficient rival to survive or compete effectively.

The result of a vertical margin squeeze is similar to that of refusal to supply, in that other companies are either prevented from entering the market in the first place, or – having entered the market – are forced to exit.

Case study – vertical margin squeeze: Telefónica

In 2003, the European Commission launched an investigation following a complaint lodged by France Telecom España alleging that Telefónica was engaging in a margin squeeze in the Spanish broadband markets. At the time, Telefonica was a vertically integrated operator, active in both the wholesale and retail ends of the supply chain.

The Commission found that Telefónica would not have been able to trade profitably with the same wholesale pricing as it charged its competitors and therefore that its pricing of the upstream services would exclude an equally efficient competitor. The Commission found that Telefónica had infringed Article 102 TFEU by charging unfair prices and, in particular, through margin squeeze practices in relation to broadband access in Spain. As a result, it imposed a fine of €151 million on Telefónica. The company appealed the European Commission's decision, but it was upheld by the General Court (the European Court of First Instance). The case is currently on appeal to the ECJ.

2.3.3 Information misuse

Vertically integrated companies can, legitimately, be party to information from other companies. For example, a company seeking access to essential services provided by a vertically integrated organisation (such as those requiring the use of a network) will need to provide a variety of information to that organisation, some of which may be commercially sensitive.

This might include information that relates to the customer base the company is targeting, which could be misused to give the vertically integrated company an advantage. For example, it could use the information to improve the position of its own retail arm to the disadvantage of all other companies. As a result, the choices available to customers may be reduced or they may be denied access to services that would otherwise be of value.

3. Tools for achieving a level playing field

3.1 Introduction

In section 2.3, we discussed some of the ways an un-level playing field could manifest itself. These include:

- refusal to deal;
- vertical margin squeeze; and
- information misuse.

The potential for these and other issues to arise has been addressed in a variety of ways in other markets.

For example, some markets place specific requirements on firms with control over essential facilities to provide other companies with access to these facilities. These requirements may be in the form of rules that govern access, which reduces the risk of anti-competitive behaviour before it occurs.

As with instances of a refusal to deal, some markets choose not to rely solely on competition law to address vertical margin squeeze. Instead, they supplement the legal framework with access codes that set out rules for determining and applying access charging arrangements. The use of these codes can help mitigate the risk of such behaviours occurring. Provisions for such codes are included in the Water Bill.

The risk of a vertically integrated company misusing information is reduced by separating that company's activities. This separation may come from rules requiring the company to have functional separation, or it may be delivered through compulsorily or voluntarily selling off ('divesting') parts of its business. This would also address any incentive to apply a margin squeeze.

3.2 Methods for achieving a level playing field

There are regulatory tools that we can use to achieve a level playing field. These tools fall into two categories:

- **ex post tools**, which are used to remedy the impact of anti-competitive behaviour after it has been identified; and

- **ex ante tools**, which are implemented within a market to prescribe required actions and so prevent anti-competitive behaviour before it occurs.

In general, ex post tools set out broad principles with which market participants must comply and then correct infringements after they have occurred. For example, the CA98 prohibits anti-competitive agreements (Chapter I) and abuse of a dominant position (Chapter II).

We share many of our ex post tools with other regulators, in particular the Office of Fair Trading (OFT), which is due to be replaced by the Competition and Markets Authority (CMA) in April 2014. Ofwat has concurrent powers with the OFT and other sector regulators under the CA98 and the Enterprise Act 2002 (EA02). In the event that a potential infringement is identified, the relevant regulator may investigate.

If a participant has committed an infringement, the tools provide for various actions to be taken. This can include:

- directions to the participant to modify or cease the conduct in question;
- imposing financial penalties;
- requiring restructuring of the participant company (to require some degree of separation); or
- other wider measures (such as amending existing regulation or the sector itself).

Although ex post tools generally require compliance with high-level principles, they are not restricted in their level of prescription. For example, they can include a specific requirement to ensure separated businesses do not exchange confidential information relating to a third party or other specific behavioural remedies. But the compliance solution remains based on enforcement after the event.

Ideally, the enforcement provisions of ex post tools are never used if all companies comply with their obligations – and all companies are provided equal opportunity to provide services to customers. But the experience of other sectors shows that, whether by accident or design, companies do not always comply with the rules. So, any non-compliance needs to be investigated and enforcement action taken where appropriate.

An alternative approach to enforcement is to seek to avoid non-compliance in the first place by detailing the required actions. Ex ante tools do this by describing what

market participants should do to limit the possibility of an infringement of the high-level principles. The extent of detail provided in such tools varies but might include:

- charging rules for a given service;
- certifying the capability of a party to perform a service before it enters the market; or
- defining the processes for data exchange to make customer switching easier.

Any failure to comply with the requirements can be detected relatively quickly and appropriate remedial actions applied.

3.3 Tools in the water and sewerage markets

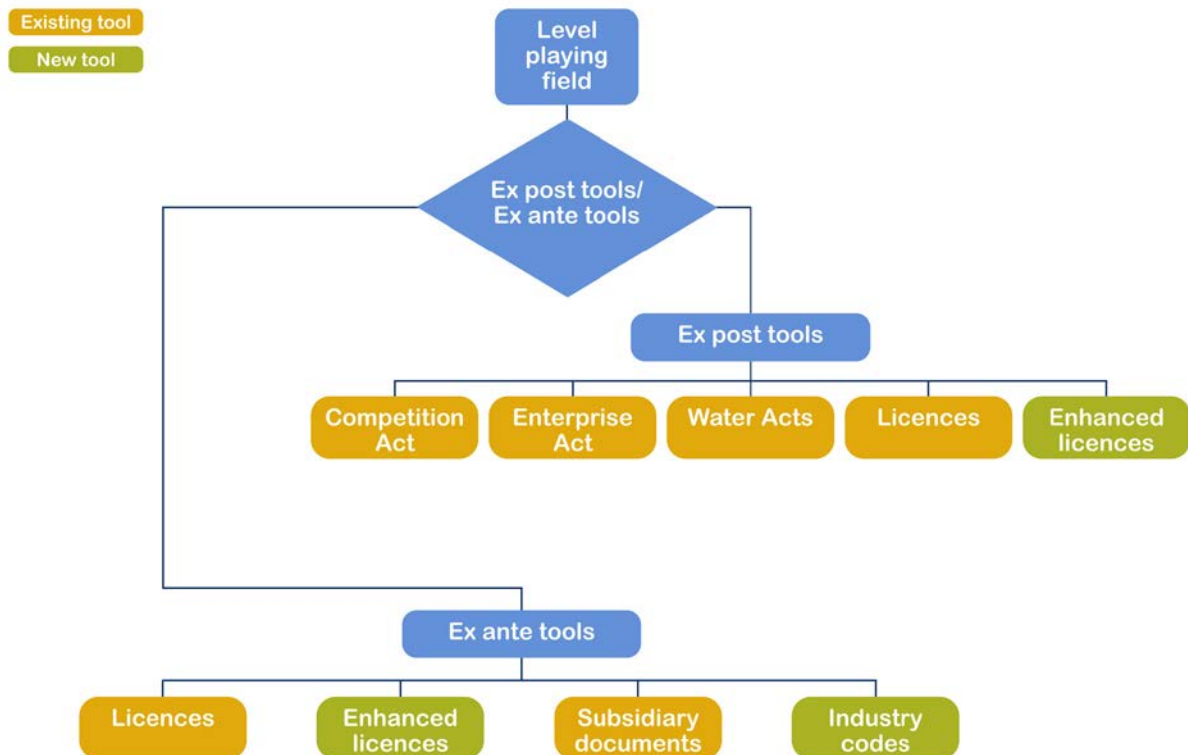
We already have a number of tools available to us to regulate the water and sewerage markets. Concurrent powers under the CA98 and sector-specific legislation – for example, the Water Industry Act 1991 (WIA91) – provide us with a number of ex post tools through which we can ensure the existence of a level playing field. Companies' licences include some ex post elements. We discuss these in more detail in section 3.3.2 below.

Licence arrangements also provide a series of ex ante tools. Some of these are contained wholly within the licences; others are supplemented through the use of subsidiary documents such as the customer transfer protocol.

Given the reforms in the Water Bill, we need to consider whether the current measures will be sufficient to ensure a level playing field – or whether extra, sector-specific tools will be required to supplement what is already available.

Figure 2 below identifies the existing tools and highlights where new ones could be introduced. It should be noted that some of these tools are shared with other sectors, for example, the investigation and enforcement powers under the CA98 and the EA02 are shared with the OFT and other concurrent regulators.

Figure 2 Overview of level playing field tools



The Water Bill already identifies some new ex ante tools in the form of various codes and charging rules needed to support the new arrangements. A review of other utility markets shows that codes are often used to help deliver a level playing field. These tools are grouped together under the ‘industry codes’ heading in figure 2.

Another option is to enhance the existing licence arrangements. These enhancements could provide either ex post or ex ante tools to help achieve a level playing field.

In the rest of this chapter, we discuss the existing and possible new tools that could be used to provide a level playing field.

3.4 Existing tools

3.4.1 Legislation

The legislative framework for UK competition law is set out in the CA98 and the EA02. This framework applies to all sectors of the economy, although Ofwat has concurrent powers with the OFT to enforce them in relation to commercial activities connected with providing water and sewerage services.

The WIA91 also gives Ofwat powers to address company behaviours.

Competition Act 1998

In common with a number of other ex post tools, the CA98 provides for a level playing field by stipulating high-level requirements with which parties must comply. Unlike ex ante tools, these requirements do not stipulate **how** parties should ensure compliance. Instead, they set out the powers regulators and (or) other government bodies have to enforce compliance.

Chapter I of the CA98 prohibits agreements that prevent, restrict or distort competition. Chapter II prohibits the abuse of a dominant position². Where an anti-competitive agreement or abuse of a dominant position is reasonably suspected, Ofwat has concurrent power to investigate and take appropriate enforcement action. Financial penalties can be up to 10% of the infringing company's turnover, which provides a significant compliance incentive.

Enterprise Act 2002

Ofwat and (or) the OFT can carry out market studies in the water sector. If there are reasonable grounds for suspecting that any feature or combination of features of a market prevents, restricts or distorts competition, we can:

- make a market investigation reference to the Competition Commission (which is due to be replaced by the Competition and Markets Authority in April 2014); or
- accept undertaking(s) in place of a market investigation reference.

² To the extent that the agreement or conduct may affect trade between member states, these prohibitions are contained in Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU).

The EA02 provides broad powers for the Competition Commission to make market-wide orders to remedy an identified problem, providing a significant incentive to market participants to comply. Participants in a market that is under investigation may choose to give an undertaking in order to avoid a market investigation reference.

In common with the CA98, the incentives provided by the powers in the EA02 are strong but the timescales for enforcement are long. In order to address this, the new ERR13 provides that a market study notice must be published if Ofwat or the CMA intends to study a market, and a decision must be made within six months on whether it intends to make a market investigation reference. Also, the statutory time limit for market investigations has been reduced from 24 months to 18 months. These changes take effect from 1 April 2014.

In comparison to the timescales within which ex ante tools can correct behaviours, these are still significant. This reflects the evidence gathering and investigation necessary to justify any enforcement action.

Water Industry Act 1991

The WIA91 provides a number of tools that can be used to help ensure a level playing field. For example, licence conditions can be modified.

The WIA91 also enables us to determine disputes between market participants in various circumstances. For example, section 66B of the WIA91 governs the situation where a water supply licensee wishes to introduce water into the network of an appointed company. The appointed company may only refuse such permission if certain conditions are met. In the event of a disagreement, section 66D(1) of the WIA91 provides that the water supply licensee can refer the matter to Ofwat for determination. Another example is the determining of access agreements under section 66D(2) of the WIA91.

Such referrals require us to investigate the circumstances before issuing a determination. This can be a time-consuming process, resulting in delays before corrective measures can be implemented.

As noted above, the ERR13 requires Ofwat, together with other sectoral regulators, to consider whether the use of powers under the CA98 are appropriate before taking any enforcement action or imposing a penalty under sectoral powers. If we consider

that it would be more appropriate to proceed under our CA98 powers, then we are prohibited by law from using sectoral powers.

3.4.2 Licences

The current arrangements include:

- **instruments of appointment** – containing the various conditions applicable to appointed water and sewerage and water only companies (including new appointments); and
- **water supply licences** – mainly embodied in a set of standard licence conditions to which licensed entities are bound.

We refer to these collectively under ‘licensing’.

Ex post elements of licences

The licences specify a number of provisions with which licensees must comply. The example below shows the ex post elements contained within the current licensing arrangements.

Example licence requirements – appointed companies

Condition R requires companies not to show undue preference toward/discriminate against water supply licensees or their customers.

This licence condition does not provide any detailed guidance. It is for appointed companies and licensees to establish appropriate processes and procedures to ensure compliance with their requirements.

Ex ante elements of licences

Existing appointed company licences already contain a number of ex ante requirements that help to provide a level playing field. These recognise that the need to provide a level playing field not only applies between the appointed companies and water supply licensees, but also between water supply licensees themselves.

Example licence requirements – appointed companies

The appointed company conditions include the following.

Condition F requires regulatory accounts to be published (for which we provide guidance to the industry in the form of the regulatory accounting guidelines, or ‘RAGs’). The aim of this is to increase transparency by providing comparable measures for the various specified elements (such as capital values and operating costs) across all companies.

Condition R contains a number of requirements, including:

- to develop, publish and comply with an access code – this ensures all parties wishing to seek access to the company’s network are treated equally;
- to ensure interactions with a related water company (that is, in which the appointed company has an interest) are at arm’s length to avoid anti-competitive behaviour, and to produce a compliance code in assurance of this requirement; and
- to keep information provided by a water supply licensee confidential and not to disclose it within its business (other than for the specified purposes) – to ensure the appointed company’s in-house retail arm is not provided with information relating to one of its competitors.

Condition S requires appointed companies to comply with the customer transfer protocol to make market operation easier (that is, to ensure the efficient transfer of a customer between the existing and new retailer) and ensure all parties are treated equally.

Example licence requirements – water supply licensees

Water supply licensees are also subject to conditions that seek to guard against behaviour that could distort competition. These conditions include:

- **standard condition 2**, which requires the licensee to keep information provided by an appointed company confidential and not to disclose it (other than under specified circumstances);
- **standard condition 6**, which requires the licensee to comply with the customer transfer protocol; and
- **standard condition 7**, which prohibits the licensee from trading within the area of an appointed company (if that licensee is an associate of the appointed company).

How prescriptive these requirements are varies. In some cases, the requirements are expressed in quite detailed terms – particularly if they are supported by legally binding supplementary information. For example, the access code and compliance code referred to in licence condition R must follow our guidance on these subjects. Below, we consider the use of these types of subsidiary documents in more detail.

3.4.3 Subsidiary documents

Licence conditions for appointed companies and licensees already refer to a number of subsidiary documents and protocols that provide more detailed requirements. How prescriptive these documents are varies. For example, the customer transfer protocol identifies the process as a series of steps. It identifies the:

- data to be provided;
- format in which they are to be provided; and
- timing of provision.

It also specifies:

- when objections to a transfer can be made;
- what should happen if two retailers fail to agree;
- the dispute process; and
- what happens after the dispute has been resolved.

It ensures that all parties involved in the process have a clear understanding of their obligations and the options available when there is a breach.

The various levels of prescription reflect the degree of flexibility that may be permitted in meeting the different requirements. Ensuring the transfer of a customer from one retailer to another requires the exchange of precise information within specified timescales to enable the process to be completed successfully. So there is little scope for flexibility.

On the other hand, there may be a number of ways in which an appointed company can meet the requirements of licence condition R to ensure interactions with a related licensee are at arm's length. By only providing high-level requirements, we provide scope for appointed companies to seek the most efficient ways to meet the requirements without compromising the overall objective.

3.5 Proposed changes to existing tools

3.5.1 In-area trading ban

In the water sector in England, many of the current water supply licensing entrants are associated with the existing appointed companies but operate at arm's length

from them. So, there is a risk that appointed companies could favour their own arm's length entrant over other entrants. To address this risk, the UK Government established the in-area trading ban in legislation, which prevented entrants from trading within the area of their associated appointed company.

The ERA13 repealed the legislation relating to the in-area trading ban. We fully support this and propose to remove the current standard condition 7 of the water supply licence as soon as the appointed companies reach a better understanding of the likely remedies they will be required to implement in order to deliver a level playing field between the wholesale and retail elements of their integrated businesses.

3.5.2 Background

There are currently a number of monopoly water companies operating in specific regions across the UK. These appointed companies are licensed to serve specific geographical regions (their 'areas of appointment'). They cannot offer services to customers outside this area. But they can set up subsidiary companies that operate at arm's length to the appointed business and obtain a water supply licence (see section 1.2). In fact, most of the new entrants that have water supply licences for retail purposes are these types of subsidiaries.

The in-area trading ban was designed to prevent subsidiaries of existing appointed companies from switching customers 'in the area' of their associated appointed company. It seeks to address the risk of undue discrimination between the appointed company in favour of their arm's length associate rather than another new entrant. So it is highly relevant to discussions of how to deliver a level playing field in emerging water markets.

3.5.3 Impact of the in-area trading ban

In its Water White Paper, the UK Government identified that the existing in-area trading ban was restricting licensees that were operating as arm's length subsidiaries of existing appointed companies from offering national contracts to multi-site customers that may wish to move to a single national retail provider. The Government considered that with the existing ban in place, there was not a level playing field.

And as early as 2007-08, in a review of the competition arrangements in the water sector, we also recognised that the existing in-area ban did not support a level

playing field for a non-household retail market or maximise levels of choice and rivalry for multi-site customers and we therefore fully supported the removal of the in-area ban from primary legislation. This document sets out our approach to removing the complimentary provision from water supply licensing licences.

We remain concerned about the potential risks of undue discrimination between, for example, the wholesale and retail elements of the existing, vertically integrated appointees (as set out above in this document). Therefore, we need to consider whether there are particular measures needed to address this alongside the removal of the restriction. This latter point is a much larger risk to delivering a level playing field for a non-household retail market which is being faced by all 'out of area' retailers currently and similarly affecting a much larger group of non-household customers.

3.6 Possible new tools

3.6.1 Enhanced licences

Some licence modifications will be necessary to reflect the requirements of the Water Bill. In developing these changes, it is appropriate to consider enhancements to the licences to strengthen their contribution to delivering a level playing field.

For example, the licences could be changed to require the appointed companies to introduce some degree of functional separation of their retail activities from the rest of the business. Such controls would need to correspond to a particular discrimination risk, and these requirements would provide greater transparency and increase the assurance that the retail arm would be treated in the same way as other water supply licensees.

There are precedents for such separation conditions in other sectors. For example, in 1995 new licence conditions required British Gas to introduce certain controls that led to a degree of separation between its trading business and its other activities. The conditions included:

- locating staff in separate buildings;
- separating previously common services such as financial and management accounts, payroll, IT services, legal, personnel and general administration;

- preventing information flows between the two businesses, except under specific conditions (such as if a shipper/supplier had given permission for the information transfer, or if the information was in the public domain); and
- appointing a senior compliance officer, with the appointed individual subject to approval by the regulator.

In developing the retail market requirements for Scotland, the Scottish Government decided to go one step further, requiring not only functional separation but also legal separation, while retaining integrated ownership.

Separation requirements – Scottish Water

The 2005 Water Services etc. (Scotland) Act envisaged that Scottish Water would establish a retail operation that was legally distinct from its wholesale entity. The new operation would be licensed to carry out retail activities in competition with new entrants, while the remainder of Scottish Water would be required to treat the new retail undertaking as it would any other retailer, no more nor less favourably.

The Water Industry Commission for Scotland (WICS) imposed a number of regulatory measures to support this legal separation. These included:

- an obligation that the retail undertaking comply with a series of requirements designed to ensure it was operating on a fully arm's length basis (in governance, managerial and financial terms, see <http://www.business-stream.co.uk/about-us/governance-and-compliance/our-licences>) from the wholesale undertaking – the right of the retail undertaking to seek and retain customers in competition with other retailers was dependent upon compliance with this requirement; and
- effective information and resourcing ring-fencing to ensure the retail undertaking did not, and could not be seen to, have access to confidential information held by the wholesale undertaking.

WICS also required Scottish Water to account for its wholesale and retail business on a stand-alone, fully self-financing basis in advance of legal and physical separation. In WICS' view, these steps helped ensure a level playing field and were further important contributions to prevent cross-subsidies.

WICS continued to monitor progress of separation activities and, in 2012, Business Stream (the retail entity) confirmed that it had fully separated from Scottish Water.

It should be noted that legal separation of the appointed water companies' wholesale and retail operations is **not** contemplated within the Water Bill.

If functional separation of wholesale and retail activities were considered necessary to ensure a level playing field, new ex ante requirements could be put into companies' licences. The precise requirements would depend on the extent to which separation was considered necessary to ensure a level playing field and where particular risks existed.

3.6.2 Industry codes

The use of industry codes is widespread in other sectors and includes what are often referred to as 'market codes'. They are generally given effect by licence conditions that bind licensees to comply with those codes. The Water Bill makes specific provision for statutory (binding) codes to be issued, and enables Ofwat to make consequential licence modifications where it considers it necessary or expedient to do so.

Codes identify roles and responsibilities, and may address market arrangements. For example, they may:

- define the way in which a commodity is traded;
- define the rules for access to an essential service; or
- address operational arrangements, such as the technical requirements for connection to a network.

For example, a code could be used to require a retailer to provide specified data and information to an appointed company to enable charges for the use of that company's network to be calculated correctly. The code – or more likely a detailed procedure beneath it – would specify the timing and format with which the data are to be provided and any data validation requirements. Such requirements would support a level playing field through enhanced transparency, providing benefits to:

- retailers, which would be assured that their charges would be based on validated data they had provided and that the rules were being applied equally to all retailers;
- appointed companies, as retailers would have an obligation to provide them with the consistent information they needed for aggregation purposes, for forecasting and network operation; and
- customers, who would be able to confirm the accuracy of charges on their bills.

The codes could also include an assurance process which would give both retailers and appointed companies confidence that the information provided was accurate.

Below, we describe how codes are used in the Great Britain electricity sector. This is to illustrate the types of codes that may be developed covering a variety of network operators. Another example of industry codes are the Market and Operational Codes for the Scottish water market.

Use of codes – Great Britain electricity sector

Operational network codes, such as the Grid Code, the Connection and Use of System Code (CUSC) and its distribution equivalent (DCUSA) set out the conditions required to connect to the transmission or distribution network and the basis for using those networks, including charging arrangements. This enables parties to understand the applicable terms and conditions, and to factor these into their business cases when deciding when and where to invest. The codes also set out procedures for changing (modifying) the arrangements.

The Balancing and Settlement Code (BSC) sets out the requirements for entry and exit to the wholesale and (or) retail markets. It includes:

- pricing rules, which address the calculation of prices relative to electricity shortfalls or surpluses;
- measurement requirements;
- procedures for providing the market and network operators with the information necessary to run their systems; and
- obligations on network operators to provide information to participants in a timely manner to enable others to make informed business decisions.

The Master Registration Agreement governs the customer transfer process. It sets out requirements for:

- registering customer meters;
- identifying who the supplier is;
- the type of customer; and
- the location of the meter.

In conjunction with the BSC, it sets out rules to make the customer transfer process easier.

Some of these codes contain charging rules that give clarity and certainty around the cost (and conditions attached) of services. In the Great Britain electricity sector example above, such charging rules are given authority by licence conditions that impose an obligation on licensees to comply with the relevant codes. But as the Water Bill makes explicit provision for statutory charging rules, licence conditions may not be required for this purpose.

Industry codes are often supported by more detailed documents. The levels of prescription provided by such supporting documentation can be very effective in establishing a level playing field and in delivering benefits to market participants and customers. But it is important to ensure that the level of prescription is not so onerous as to discourage new entrants or lead to inefficiencies.

How prescriptive codes and subsidiary documents are may vary depending on the number of participants in the market – and the maturity of that market. In the early stages, particularly in the water and sewerage markets where there are relatively few service providers, greater prescription provides advantages to all parties. Companies can understand the requirements placed upon them and learn how to behave within the new market arrangements. Over time, as parties' understanding of the market improves and the number of participating companies increases, a reduction in the degree of prescription supported by regulatory oversight may be appropriate. This will provide companies with greater flexibility to innovate and generate industry- and market-led solutions to better meet customer requirements.

The governance arrangements for these codes are important since they will control the way in which the market develops. The processes for raising, assessing and agreeing changes to the market codes must safeguard the interests of customers and participants alike, ensuring that developments further the interests of all parties rather than unduly favouring a discrete few. We have published a separate discussion document on this, which is intended to be read alongside this one.

4. Issues for discussion

In this document, we have considered the range of possible tools available to deliver a level playing field.

Our primary focus in this context is to protect consumers' interests and to deliver arrangements consistent with our duties and the UK Government's better regulation principles. Inevitably, there will be trade-offs between:

- the effectiveness of the tools in delivering a level playing field;
- risks to the delivery of customer benefits;
- prescription and certainty provided by clear rules;
- flexibility; and
- the cost of compliance.

It is highly unlikely that a single tool will be able to address all of these points fully. So both our ex post and ex ante tools will be vital to help ensure a level playing field. In establishing a level playing field, we want to make sure that any regulatory safeguards help to provide the right incentives to appointed companies to encourage them to innovate and respond to the needs of their customers.

We also want new companies to enter the market to provide customers with a choice relating to both price and levels of service. This means that a careful mix of regulatory tools will be required – especially as we plan to remove an existing ex ante control from water supply licences (in-area trading ban), which means other measures may be necessary to help ensure a level playing field.

We are currently considering whether there may be a need for us to create additional ex ante rules (for example, in licences and/or industry codes) to supplement our existing controls and powers.

In the following chapter, we consider some next steps in this process.

5. Next steps

We envisage that an important next step in this process is for appointed companies to engage with new entrants (other just than their own associated water supply licensing entrants) and discuss with them their potential concerns about undue discrimination – particularly between each appointed company's wholesale and retail arms – and to seek to agree a set of potential remedies that could address those concerns in the most cost-effective way for customers. The outcome of these discussions should be a set of potential remedies that both parties agree, if implemented, would deliver a level playing field for a retail market in that appointed company's area.

Once there is an agreed set of potential remedies or clear evidence that best endeavours have been made to reach an agreed set of potential remedies, we will remove the in-area trading ban from the licenses of any associated water supply licensed entrant retailers of those appointed companies. Therefore those companies that take early steps to address these issues can expect to have the in-area trading ban removed more quickly than those that do not. In any event, we intend to take forward the removal of the in-area trading ban for all companies by April 2015 – the start of the next five-year price control period and two years before the retail market opens in April 2017.

In order to take forward these issues expediently, we propose the following.

- Existing appointed companies should engage with a minimum of two 'out of area' retail entrants. These could be arm's length subsidiaries of other appointed companies, but cannot include their own arm's length water supply licensed subsidiaries.
- Through these discussions, appointed companies and entrants should make best endeavours to identify and agree a range of potential ex ante remedies that they and the entrants consider will be required in order to:
 - satisfy all parties that the retail arm of the integrated appointed business is not receiving preferential treatment compared to the entrant retailer (that is, that there is a level playing field); and
 - ensure that the costs of implementing those remedies is minimised for customers.

- Parties may consider that further ex ante measures are not necessary and that these risks can be dealt with effectively through ex post controls. All parties will need to agree to this approach.
- In considering what – if any – ‘remedies’ may be required, appointed companies and entrants may wish to review the ones that have been introduced in other regulated sectors, such as the Scottish governance code (see section 3.4.1). But clearly market participants may wish to explore alternative arrangements as they see fit.
- Once all parties are able to agree to a set of remedies or requirements, we will take forward immediately the necessary consultation to remove the in-area trading ban for that appointed companies’ associated subsidiaries. Companies do not need to have implemented these new remedies. They need simply to agree them.
- If companies are unable to agree a set of remedies or requirements, then we propose to consult on removing the in-area trading ban in any event from all standard water supply licensing conditions for the next price control period from 2015. We may also seek to remove the ban sooner, but this will depend on the sector’s response and the extent to which market participants take steps to address these issues themselves.

We hope that this approach will allow market participants to propose an initial, sensible set of remedies that best reflect the diversity of organisational structures and circumstances across appointed companies. We also hope that it will deliver a level playing field while minimising the costs to customers of implementing those remedies.

This exercise may also help to inform companies’ business plans for the 2014 price review and any associated costs that they may expect to incur in implementing these remedies.

5.1 Future engagement

This document is intended to stimulate discussion, and we welcome your views on any of the issues raised.

Responses to this document will help us to consider what remedies are appropriate to ensure a level playing field for the water market. Please send your comments to LPFinbox@ofwat.gsi.gov.uk.

We think that there will continue to be an ongoing dialogue about the issues contained in this document. This is one of a series of both Ofwat and industry-led discussions that will be conducted over the next few years. For example, we have published a [discussion document on the governance arrangements for market codes](#) alongside this one.

Although Ofwat would hold certain powers under the legislation envisaged by the Water Bill, we think that the process to develop the market framework will be part of the wider dialogue with the sector. We are looking forward to a constructive and open debate about these issues.

As well as the Open Water work, we will manage a regulatory work stream to develop the set of codes and licences that will be needed in the new market. This work will run alongside the Open Water programme.



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