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February 2017

Trust in water

# **Derogations Guidance - summary of responses and further consultation on certain aspects following MAC and WRC changes**

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## About this document

This document sets out our response following our 31 August 2016 to 27 September 2016 consultation on our proposed approach to derogations and consults further on certain aspects of our derogations guidance following the restructuring of the Wholesale Retail Code (WRC) and the Market Arrangements Code (MAC) as part of our consultations on the WRC ([WRC consultation](#)) and MAC ([MAC consultation](#)) and as a result of responses to that consultation.

**Having considered responses to our consultation, we are not proposing to change our derogations policy. However, given the changes made to the WRC and MAC on which we consulted in 2016 and the amendments made to our guidance as a result, we wish to ensure that stakeholders have an opportunity to raise any issues that they feel should be considered in light the proposed amendments and, in particular the proposed implementation of the outcome of our derogations process through the revised WRC and MAC structure.**

We also outline as part of this document clarifications we are making to schedule 8 of the MAC as this relevant to the implementation of the outcome of our derogations process for integrated Appointees who are subject to the Stapling Condition in their Instruments of Appointment.

Alongside this document we are also issuing updated derogations guidance which contains the revised application process we envisage using. This has not changed significantly from the original process and is still envisaged as being created as an online process to aid stakeholders in completing any applications easily.

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## 1. Background

A derogation is a direction from Ofwat which relieves a licensee or appointee from compliance with certain of its obligations in the Wholesale-Retail Code (WRC) as it applies in Wholesale Contracts between wholesalers and licensed retailers and also through written arrangements between businesses in an integrated appointee required by Condition R4 of their Instrument of Appointment (the “Stapling Condition”).

We outlined some examples in the previous consultation document and guidance of the circumstances when a derogation may be sought by a company:

- to mitigate the consequences of non-compliance with obligations in the WRC due to unforeseen (short term) circumstances;
- to mitigate the consequences of non-compliance with obligations in the WRC in the short term while a vital piece of water/sewerage infrastructure is being repaired or serviced;
- to mitigate the consequences of non-compliance with obligations in the WRC while changes to the market codes are being made and where unforeseen issues have arisen;
- to allow a small company time to ensure it meets the requirements of the market operator’s performance framework within the WRC (CSD 0002); and
- to ensure proportionality for a company with a small number of eligible customers.

We stated that retrospective derogations will not be granted by Ofwat.

The water sector has worked with us to develop the WRC, a statutory code which sets out the terms and conditions of contracts between wholesalers and retailers and the underlying processes and operational arrangements that will govern the retail market for the supply of water and wastewater services to business customers<sup>1</sup>.

As part of our duties as an economic regulator it is important that we consider proportionality when we monitor company compliance with the WRC. In addition, we do not want to stifle innovation in the the expanded retail market.

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<sup>1</sup> When we refer to business customers this includes all eligible non-household customers. Non-household customers could include businesses, public sector organisations and charities.

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Given:

- the different scale and sizes of companies within the water sector;
- the different scope of the competitive market in areas governed by Welsh Government policy; and
- the different commercial structures of companies within the water sector,

It is possible that instances will occur where certain companies will consider compliance with the obligations in the WRC to be disproportionate or inappropriate or where short term compliance is not possible. In these instances, derogations from compliance with certain obligations may be appropriate.

We consulted on our proposed derogations policy in August 2016. Responses to that consultation enabled us to conclude that our derogations policy was appropriate. A summary of those responses and the conclusions reached as a result of that consultation are set out in Section 2.

In November 2016 we consulted on the WRC and the MAC. In particular, we consulted on a revised structure for those documents. While this did not have a direct impact on our derogations policy, it did have an impact on how the outcome of our derogations process would be implemented. We consider it important that stakeholders have an opportunity to comment on the revisions to the derogations process and so Section 3 sets out areas on which we are consulting further.

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## **2. Responses from the previous consultation (prior to WRC and MAC restructuring)**

### **Responses to previous derogations guidance**

This section addresses the responses we received to our consultation on the derogations guidance. The consultation ran between **31 August 2016 and 26 September 2016** and, therefore pre-dated the WRC consultation and the MAC consultation when we proposed structural changes to those documents. **We received 10 responses to our consultation.**

### **Previous Consultation process and questions**

In September 2016 we consulted on our approach to derogations from the market codes. We asked for views on the draft derogations guidance. In particular, we welcomed responses to the following questions:

1. Do you agree with the proposed structured approach to derogations from compliance with obligations in the WRC?
2. Do you agree with the criteria outlined in the guidance?

We did not propose to allow applications for derogations from obligations in the Market Arrangements Code (MAC).

### **2.1 Our considerations and responses to the first consultation (prior to WRC and MAC restructuring)**

This section summarises our position in the consultation on the derogations guidance, the comments we received and our final position having considered these comments.

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## 2.1.1 Level playing field

### Ofwat position in consultation

In our draft derogations guidance within the application request we stated that we required “*a description of how the granting of this derogation would not unreasonably adversely affect competitors.*” Alongside this, within the assessment criteria, we were clear that we would take into account “*any competitive advantage or other hindrance of the competitive process that may arise from granting the derogation.*”

### Stakeholder comments

A stakeholder commented that they believed that the role of derogations should be considered through the optic of maintaining a level playing field, as this would help to facilitate the most effective non-household retail market possible.

### Our conclusions

Whilst we did not specifically refer to the level playing field requirement in the draft derogations guidance we do believe that any items which affect the balance of competition and as such influence the extent to which a level playing field is possible, that these implications should be made clear and form a robust part of our assessment into the derogation request.

Following this feedback, we have added reference to level playing within the revised submission form and assessment criteria.

## 2.1.2 Unforeseen circumstances

### Ofwat position in consultation

Within our draft guidance we stated derogations may be sought “*to mitigate the consequences of non-compliance with obligations in the WRC due to unforeseen (short term) circumstances.*” We were also clear that derogations would not be granted retrospectively and Ofwat would still consider whether enforcement action would be necessary/required.

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## **Stakeholder comments**

It was commented by a respondent that they did not believe that the derogations due to unforeseen circumstances should apply. The rationale was that market participants should be actively managing and controlling these risks, and as such it was in the interests of both end-customers and the market as a whole that such derogations should not apply.

## **Our conclusions**

We continue to believe that there could be instances where unforeseen circumstances could have reasonable grounds for a derogation. However, we do recognise that market participants should actively be managing such risks and such instances should be rare.

We are also clear that we maintain the right to take enforcement action if a breach of obligations has occurred where a derogation is not in place.

We have updated the guidance to put greater emphasis on this point.

## **2.1.3 Criteria**

### **Ofwat position in consultation**

In the consultation document we asked if stakeholders agreed with the criteria outlined in the guidance. Criteria were outlined for both the submission of the request and how we would approach our assessment.

## **Stakeholder comments**

The majority of respondents (eight) supported the criteria and approach Ofwat had taken.

Within the comments from those that agreed with our approach one stakeholder commented that it was important that there should be a sufficiently “high-bar” to demonstrate that a derogation is required and they agreed that derogations should, by default, be time-limited.

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Another felt that, as part of the criteria, it would also be useful to see the short term unforeseen circumstance criteria broadened to include any form of exceptional circumstance where the granting of a targeted derogation would provide customer benefits or limit an unforeseen/unintended consequence for a market participant.

One stakeholder was unsure if Ofwat wanted feedback on the criteria for submission or assessment and felt that because of this there was no clear set of criteria.

The final stakeholder, felt that the depth and specific nature of the minimum requirements undermine the objective of ensuring proportionality for a company with a small number of eligible customers.

## **Our conclusions**

We are glad to see that the majority of stakeholders agreed with our criteria outlined in the derogations guidance. Following the feedback we have broadened the criteria to reflect in the guidance for unforeseen circumstances to include exceptional circumstances. We will, however, continue to emphasise that enforcement action remains an option and that we expect companies to comply with their obligations.

In relation to the burden of the application for derogations, companies have an obligation to be compliant with the WRC and as such should be fully aware of their obligations and the implications these have for their business and operations.

We do not believe that the minimum criteria we have outlined are over burdensome but have added a statement regarding proportionality of the detail of information required for the derogation request based on the extent of the request submitted and size of the customer base. We will, however, ask for further information from a company if we feel that their request does not sufficiently provide the assurances and information required for Ofwat to make its assessment.

### **2.1.4 Consultation with other stakeholders**

#### **Ofwat position in consultation**

In the draft derogations guidance we were clear that as part of the assessment process Ofwat may seek advice or comments from any affected parties through the consultation process.

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## **Stakeholder comments**

One stakeholder felt that we consider that consultation with all relevant stakeholders should be sought for all derogation applications. They felt this would help to ensure that the principle of the level playing field is maintained and that market participants have an opportunity to comment on the application.

## **Our conclusions**

One of Ofwat's goals is to ensure that regulation is proportionate. Whilst we accept there will be instances where consultation will be required, there may be a small number of cases where an industry wide stakeholder consultation would be considered disproportionate or unnecessary given the extent of the application.

In granting a derogation we will consider the fairness and potential impact of any derogation on any relevant or related third parties especially the parties to s66D/117E Agreements

As such, we propose that the applicant should declare all parties to s66D/117E Agreements which would be affected by the derogation and they will be consulted as part of our assessment of the derogations request. Given the nature of the contractual arrangements we would expect counterparties to a Wholesale Contract to agree to the derogation before it is granted.

We also believe reserving the right to consult stakeholders more widely if we feel it is appropriate to do so achieves a balance between consultation and the extent of regulatory burden. We also have been clear that all decisions will be published on a public register to ensure transparency.

## **2.1.5 MAC**

### **Ofwat position in consultation**

#### **Stakeholder comments**

Three stakeholders felt that derogations from the MAC were not required or could not name any instances where they felt they would be required and a further four stakeholders agreed with Ofwat's approach.

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One stakeholder asked what was meant by the reference to “an amendment” being made by means of a Code Change Proposal and if this was contrary to a number of the statements in clause 1.3 of the consultation document, such as:

- a derogation will be granted to an individual licensee or appointee;
- a derogation will generally be for a fixed period of time and will have an expiry date; and
- Derogations will be reviewed and performance towards compliance monitored.

## **Our conclusions**

### **2.1.6 Types of derogations**

#### **Ofwat position in consultation**

We recognise that transparency is important. We intend to be as transparent and open as possible about the process for assessing derogations by consulting widely as appropriate and by publishing all derogations granted in the public register on the Ofwat website.

#### **Stakeholder comments**

We support Ofwat’s commitment to timely transparency.

Another stakeholder commented that it would also be useful for Ofwat to provide further information on the types of derogations it is willing to consider.

## **Our conclusions**

Ofwat proposed a transparent process as we believe this is key to creating market confidence. Ofwat has further clarified as part of its revised consultation the derogation types that it will consider. Please refer to the updated guidance.

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## 2.1.7 Retrospective derogations

### Ofwat position in consultation

Derogations will not be granted retrospectively and Ofwat will still consider whether enforcement action is proportionate in the circumstances.

### Stakeholder comments

There were two comments regarding retrospective derogations. The first suggested that if retrospective derogations will not be granted how this aligns with the concept of unforeseen circumstances.

A second stakeholder agreed that derogations should not be applied retrospectively, however, they felt that in circumstance which are unforeseen and short term, a company may not know, with 40 business days' notice, that it may require a derogation. As such, the stakeholder suggested that Ofwat should consider that if it accepts a derogation then this should be back-dated to the date that Ofwat acknowledged the application.

### Our conclusions

We continue with our stance that derogations will not be granted retrospectively. To suggest otherwise would potentially allow companies to negate their obligations and apply for a derogation following an issue.

The derogations process and criteria are designed to allow for material issues to be raised in advance of them occurring and relief granted from obligations affected by those issues. As such, we believe companies should be aware of such issues and their impact. We do not want to confuse the derogations process with our [approach to enforcement](#) where a company may find itself in breach of their obligations and may discuss with us how to remedy the situation. Therefore, we maintain our position that retrospective derogations will not be granted. If a company is failing to meet its obligations Ofwat can take enforcement action.

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## **2.1.8 Wholesaler retailer relationship**

### **Ofwat position in consultation**

Ofwat was clear that it reserves the right to consult third parties. This would include any contractual relationships that would be affected by a derogation to ensure parties were in agreement and happy to continue on the 'revised' basis.

### **Stakeholder comments**

The relationship between a Wholesaler and a Retailer will be governed by the terms of the Wholesale Retail Contract which requires both parties to comply with the Wholesale Retail Code. It is unclear how any derogation granted would sit legally with this contractual relationship. Derogations in place at the time of signing the Wholesale Retail Contract can be declared and understood but derogations granted after the signing of the contract should require both parties to be in agreement. The stakeholder suggested that Ofwat in granting a derogation is required to consider the fairness and potential impact of any derogation on any relevant or related third parties.

### **Our conclusions**

In granting a derogation we will consider the fairness and potential impact of any derogation on any relevant or related third parties especially the parties to s66D/117E Agreements.

As such we propose that the applicant should declare all parties to s66D/117E Agreements and they will be consulted as part of our assessment of the derogations request. Given the nature of the contractual arrangements we would expect counterparties to an affected Wholesale Contract to agree to the derogation before it is granted.

We agree that wider third parties may need to be consulted in some instances depending on the type of the derogation being requested. For example, some derogations may have an impact on the Central System and so the comments of the market operator could be vital. As set out in Section 3, following the restructuring of the WRC, we propose that a derogation be implemented as a Code Change, which by its nature would tend to involve consultation. This is why we have reserved the right to consult stakeholders.

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## **2.1.9 General**

### **Ofwat position in consultation**

There were various comments that were provided alongside the three consultation questions these are outlined below and our response included.

### **Stakeholder comments**

One respondent commented that they were pleased to see that the guidance expressly contemplates the granting of derogations to ensure proportionality for a company with a small number of eligible customers.

Three stakeholders reemphasised that Ofwat should ensure that they consider potential unintended consequences that derogations can create, and be flexible to finding solutions. Another two respondents supported this saying that a derogation should not have a detrimental impact on non-household (NHH) customers.

A final stakeholder felt that Ofwat needed to be more direct with a statement on competitive advantage, for example, “a derogation should not provide a licensee or appointee with a competitive advantage...”

A final stakeholder commented that whilst they note that derogations should usually be temporary, Ofwat has not indicated a mechanism for following up on an existing derogation or what it will do should the derogation lead to an impact, particularly on customers, which was unforeseen or understated. We would like this clarifying in the derogations guidance.

### **Our conclusions**

We agree that as part of derogation process other potential consequences should be considered and intend to consider such consequences as part of our assessment. As part of this the assessment we will assess if there is a detrimental effect on non-household customers.

We have also been clear that as part of the derogations process we may consult third parties where required or where further information or views are felt to be required

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We have amended the guidance to outline how it envisages the process of reviewing existing derogations.

## **2.1.10 Structured approach**

### **Ofwat position in consultation**

Ofwat asked as part of the consultation if stakeholders agreed with the proposed structured approach to derogations from compliance with obligations in the WRC.

### **Stakeholder comments**

Of the six respondents all agreed with our approach. However, one respondent also noted that the application form could be made clearer if the sections were numbered.

It was also noted that where Ofwat proposed a comprehensive assessment was required that this may inadvertently be suggesting that this is a qualitative response.

### **Our conclusions**

We have amended the guidance to reflect the issues raised about the assessment being qualitative in nature. We have also numbered the proposed form, however, it should be noted that applications will occur electronically.

## **2.1.11 Period**

### **Ofwat position in consultation**

In the previous derogations guidance we suggested the following three periods:

**Definite** – a specific period of time agreed with Ofwat at which point compliance with the WRC should resume.

**Indefinite** – this would continue until a further derogation is made, or until Ofwat decides that the derogation is causing significant detriment to customers and revokes it. Such derogations would rarely be granted and companies would need to

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take measures to prove that customer detriment and/or competitive advantage would not be a consequence.

**Triggers** – Ofwat may include triggers within derogations for the termination of such a derogation (such as customer numbers, revenue etc.).

### **Stakeholder comments**

Two stakeholders made comments about the periods we suggested. One suggested there should be a default time period and the second felt that all derogations should be based on an application for a defined period of time, which in their view was two years.

### **Our conclusions**

Having reviewed our position we feel that derogations should now be considered on two basis. The first is on the basis of a defined period of time and the second is based on trigger points at which a derogation which has been granted would no longer be applicable. Please refer to the revised derogations guidance as part of this new consultation (given the restructure of the WRC and MAC) for further details.

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## 3. Derogations processes in light of revised WRC and MAC

### 3.1 WRC

Our August consultation set out that relief could be sought from the obligations of the WRC. Following our consultation on the WRC, the relevant provisions are those set out in the Wholesale Contract together with Parts 1 to 6 of Schedule 1 to the Wholesale Contract. The process for making an application for a derogation is set out in the revised Guidance.

If Ofwat is minded to grant a derogation, the derogation must deal with both the potential for enforcement action by Ofwat under s66DA(4) and s117F(4) and the terms of contracts entered into or to be entered into by a successful recipient of a derogation.

Given the revised structure of the WRC, we have concluded that the form of the derogation must be a modification to the WRC. This requirement is a consequence of the restructuring of the WRC to incorporate the Wholesale Contract and, in effect, creating a WRC which is an agreement.

The statutory basis for this is sections s66D(7) and 117F(7) of the Water Industry Act 1991 whereby the WRC can make different provision for persons or descriptions of persons. Once the modification process is complete Ofwat will issue a Direction to the Licensee or Appointee as the recipient of the Derogation set out in the Direction and the WRC modification will be an "Approved Change" as defined in the WRC.

Ofwat will have followed its derogations process before reaching a view that a WRC modification is required in order to give full effect to the grant of a derogation. As a result, it is likely that Ofwat will want to manage the timetable and/or process for such a WRC change such that it complements rather than duplicates the derogations process. So, for example, the Panel will not be expected to review the merits of a derogation against Ofwat's criteria for derogations but their view on the impact of the derogation on the Objectives and Principles will be valuable. Recent changes to the draft Market Arrangements Code on which we are consulting separately, make provision for Ofwat to do this through the "Authority Timetabled Change" process. As with other WRC changes, the final decision following the production of a Final Report as to whether Ofwat should approve a change will be for Ofwat.

As set out above, the grant of a Derogation will be made by Ofwat issuing a Direction setting out the extent of the obligations in the WRC with which the Licensee and/or

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Appointee need not comply and where appropriate, the expiry date of the derogation(s). The effect of the Direction is to amend all Wholesale Contracts to which the recipient of the Derogation is a Party. The intention is to add the relevant terms of the Direction to each Wholesale Contract as Schedule 4 and to publish the Direction on Ofwat's Website.

## **MAC**

Integrated Undertakers are subject to the provisions of the Stapling Condition which in turn refers to Schedule 8 to the MAC for interpretation of obligations in and derogations from the provisions of the WRC, for these purposes. If an integrated undertaker wishes to seek derogations from the application of the WRC as regards the written arrangements between its retail and wholesale businesses to suit its particular circumstances, application can be made to Ofwat in accordance with the Stapling Condition Derogation process set out in the Derogations Guidance. We would anticipate that this process would be considered alongside any application for derogation from the WRC itself.

As with the WRC derogation process, Ofwat anticipates that any decision to grant a Stapling Condition derogation would be implemented as a code change. However, in this case the change would be to Schedule 8 to the MAC. Again, as Ofwat will have followed its derogations process before reaching a view that a MAC modification is required in order to give full effect to the grant of a derogation, it is likely that Ofwat will want to manage the timetable and/or process for such a MAC change such that it complements rather than duplicates the derogations process.

### **3.2 The revised structure of the WRC and MAC its interaction with schedule 8 and how this relates to derogations**

Given the restructuring of the WRC and MAC and the fact that implementation of our derogations decisions have the potential to impact on schedule 4 to the Wholesale Contract and/or schedule 8 of the MAC we are therefore proposing the following changes to our Derogations Guidance:

- We are implementing a stapling conditions derogations process to provide further clarity.
- We are implementing the derogations decisions as a WRC change proposal to schedule 4 of the wholesale contract.

We are also proposing that Schedule 8 to the MAC be restructured as follows:

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- The interpretation of the WRC definitions and provisions for integrated Appointees, as set out in Schedule 8 to the MAC will continue to be in place but will be "Part 1" of Schedule 8. We consider these clarifications important for integrated companies.
  - Derogations policy will be more clearly defined in Parts following the current interpretation section. This will outline the two types of derogation that will be available:
    - Part 2 - General derogations – these are derogations identified, applied for and supported by multiple parties where an area of the codes is felt could be derogated for all integrated Appointees relieving them of their obligations.
    - Part 3- Specific derogations – this is a derogation which is specific to a single appointee and is applicable only to them for the period and under the conditions approved with the Authority. This may, for example be similar in form to Schedule 4 to the WRC if a derogation is granted in relation to the same WRC obligations.

Given the above, we are aware that if a significant number of specific derogation requests were received that Schedule 8 of the MAC could become unwieldy, and as such we intend to monitor derogation request and if this were to become an issue would consider another mechanism to implement such derogations.

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## 4. Responding to this consultation

We welcome your comments on the draft derogations guidance by **Friday 10 February 2017**. Please find below a number of questions to aid you in structuring your response to this consultation.

Given the restructuring of the WRC and MAC, we are asking stakeholder for further feedback and comment on the following:

### Updated consultation questions

1. Has the restructure of the WRC and MAC caused any additional issues that are of concern?
2. Do you agree to our proposed approach to derogations within schedule 8 of the MAC given the restructuring?

Please submit email responses to [retailmarketopening@ofwat.gsi.gov.uk](mailto:retailmarketopening@ofwat.gsi.gov.uk), with the subject '**Consultation on derogations guidance**' or post them to:

Consultation on derogations guidance  
Retail Market Opening Programme  
Ofwat  
21 Bloomsbury Street  
London  
WC1B 3HF

We will publish responses to this consultation on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among 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

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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 IT system will not, of itself, be regarded as binding on Ofwat.

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## 5. Next Steps

We welcome responses from stakeholders to the proposals set out in this consultation document and the redrafted derogations guidance. This will help us to refine our proposed approach to both the derogations process and the associated guidance. Given the limited matters on which we are seeking views, **the deadline for responses is Friday 10 February 2017.**

Following this revised consultation, which focuses on issues given the restructure of the MAC and WRC, we will issues the following:

- A MAC reponse document
- A WRC response document
- Final versions of the Codes
- Final derogations guidance