
February 2017

Trust in water

Draft Derogations Guidance

www.ofwat.gov.uk

ofwat

About this document

This document sets out guidance for applications to Ofwat by Licensees and Appointees for derogations from compliance with obligations in the Wholesale Retail Code ('WRC') and/or any WRC subsidiary document. As the WRC can apply both to Wholesale Contracts between Appointees and Licensees and also to written arrangements between the wholesale and retail businesses of an integrated Appointee, i.e. where an Appointee has an Associated Retailer, as defined in the MAC/ WRC (the latter through the operation of Condition R4 of the Instrument of Appointment, known as the Stapling Condition), this document also includes the process for Appointees seeking changes to the derogations from the Stapling Condition set out in Schedule 8 to the MAC.

This guidance applies to all Licensees and Appointees in England and Wales.

A derogation is a direction from Ofwat which relieves a licensee or appointee from compliance with certain of its obligations to comply with the WRC either as a result of it entering into Wholesale Contracts or as a result of the operation of the Stapling Condition. The power to grant derogations from compliance with these specific obligations will be introduced when the WRC is issued by the Authority. The possibility of derogations as a result of the operation of the Stapling Condition already exists in that condition and the provisions of Schedule 8 to the MAC.

Unless a derogation from compliance with a specific obligation in the WRC is granted by Ofwat, all Licensees and Appointees are expected to comply with all relevant obligations in the WRC. Derogations will not be granted retrospectively and Ofwat will still consider whether enforcement action for non-compliance is appropriate in the circumstances in accordance with our [approach to enforcement](#).

This Derogations Guidance document includes:

- our approach to derogations;
- the process for requesting a derogation from the WRC;
- the criteria for requesting a derogation;
- the assessment process for derogations;
- the proposed way in which the outcome of a derogations process will be implemented; and
- additional information and appendices that may be useful to applicants.

Contents

| | |
|---|----|
| About this document..... | 1 |
| 1. Background on derogations | 3 |
| 2. Derogation principles | 7 |
| 3. Submitting an application for a derogation | 8 |
| 4. Assessment and consultation of a derogation request..... | 10 |
| 5. Ofwat's decision | 12 |
| 6. Derogation transparency | 14 |
| 7. Appendix: Derogation application form | 15 |

1. Background on derogations

In this chapter we explain what a derogation is and the circumstances in which we consider a derogation may be appropriate.

Each derogation granted by Ofwat will generally apply for a predefined and agreed timescale. Only in rare circumstances would we grant a derogation that applies for an indefinite period.

1.1 Target audience for this derogation guidance

This guidance document is aimed at companies (Licensees and Appointees) operating within the retail business market. It seeks to clarify the process for requesting a derogation from compliance with specific obligations in the WRC and changes to the derogations from the Stapling Condition set out in Schedule 8 to the MAC.

1.2 What is a derogation from the WRC and the Stapling Condition?

A derogation is a direction from Ofwat which relieves a Licensee or Appointee from compliance with a specific obligation in the WRC in respect of its s66D/117E Agreements and in relation to the written arrangements in place between its wholesale and retail businesses required by the Stapling Condition (separate from those derogations from the Stapling Condition set out in Schedule 8 of the MAC).

For these purposes the provisions of the WRC where relief can be granted are those set out in the Wholesale Contract together with Parts 1 to 6 of Schedule 1 to the Wholesale Contract.

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 s.66D/ 117E contracts entered into or to be entered into by a successful recipient of a derogation. If it relates to the operation of the Stapling Condition it must deal with the potential for licence enforcement action by Ofwat and the terms of written arrangements between wholesale and retail businesses of an integrated appointee.

A derogation will be granted to an individual Licensee or Appointee and cannot be transferred.

Except for derogations set out in Schedule 8 of the MAC at Market Opening, a derogation granted by Ofwat will be for a fixed period of time and will have an expiry date. Only in exceptional circumstances will Ofwat grant a derogation for an indefinite period and, in any event, an indefinite derogation would contain triggers for the termination or review of such a derogation (such as customer numbers, revenue etc.). Derogations will be reviewed and performance towards compliance with the relevant provisions of the WRC monitored.

Given that the structure of the WRC is the form of a s66D/s117E Agreement, we have concluded that the form of the derogation must be a modification to the WRC. Given that there are already derogations relevant to the Stapling Condition set out in Schedule 8 to the MAC, we have concluded that the form of such a derogation should be a modification to Schedule 8 to the MAC.

A derogation should not provide a Licensee or Appointee with a competitive advantage and will only be granted where any such an advantage is perceived to arise, following an assessment by Ofwat of measures that can be applied to offset that advantage.

1.3 When would a derogation be required?

There may be occasions when a Licensee or Appointee is not in a position to comply with an obligation in the WRC. The Licensee or Appointee may consider that compliance with the obligation is a disproportionate burden or inappropriate in its particular circumstances, which may have an impact on its ability to run its business and provide services to customers. In those circumstances it seems appropriate for that company to apply to Ofwat for relief from the obligation to comply with particular provisions of the WRC.

In addition a Licensee or Appointee may make an application when faced with unforeseen unexpected, or exceptional circumstances.

Any request would be required to be accompanied by sufficient proof of the extent of the regulatory burden, as well as an explanation of the mitigating measures taken to deal with the effect of the WRC obligation on the business and why a derogation is considered appropriate.

It should be noted that if non-compliance with obligations under the WRC is advised to Ofwat, Ofwat will consider the extent to which the situation warrants enforcement action being taken.

Ofwat has also designed the stapling condition derogations process to allow for the eventuality that a general derogation applicable to all integrated Appointees may be identified and required on a temporary basis. We do not expect such requests to occur often and supporting evidence would need to be significant and sufficient to convince us that there is a genuine issue that could not be addressed through alternative means. Any such derogations would be reflected in Part 2 of schedule 8 of the MAC.

1.4 Timescale of derogations

When deciding the appropriate period of time a derogation will apply we will consider the applicability of the following:

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

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

1.5 Derogation types

We are proposing three types of derogations to provide market participants with the certainty and flexibility required to ensure the market continues to operate effectively and proportionately.

- Schedule 4 of the of the Wholesale Contract part of the WRC– these are derogations specific to a single Licencee or Appointee and are applicable only to them for the period and under the conditions approved by the Authority as regards obligations in their Wholesale Contracts.
- Part 2 - General derogations – these are derogations identified, applied for and supported by market participants where it is considered that a derogation should be granted for all integrated Appointees, relieving them of their obligations under the Stapling Condition. As a minimum supporting parties' contact details should be provided.
- Part 3- Specific derogations – these are derogations which are specific to a single Appointee and applicable only to them for the period and under the

conditions approved by the Authority with regard to the obligations under the Stapling Condition. 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.

Derogation principles

Ofwat is keen to keep the derogations process as streamlined as possible to aid companies. We have designed and are implementing a proportionate regulatory framework to support the retail market overall. Therefore, we expect requests for derogation to be unusual.

We do, however, understand that particularly small companies, such as some new Appointees, or companies with very few eligible customers such as those in Wales could still face disproportionate burdens in complying with the fullest extent of the regulatory framework and as such are putting in place a derogations process.

Our principles for derogations are as follows:

Where a Licensee or Appointee is applying for a derogation, we expect the information required to support the application to be proportionate to the time period and extent of the derogation requested in the application.

Where a Licensee or Appointee is applying for a derogation from compliance with an obligation that involves system critical or market code principles which are considered essential for market operations, the evidence supplied to Ofwat would need to be compelling to support the application.

Where a Licensee or Appointee is applying for a derogation similar to one that has been granted previously to another Licensee or Appointee this derogation can be referred to. Whilst this will help us to maintain a consistent and proportionate approach, it does not mean that a derogation will necessarily be granted. Each derogation will be considered on its own merits but examples of relevant previous derogations granted can be used as supporting evidence.

2. Submitting an application for a derogation

Where a Licensee or Appointee has identified that it cannot, or will not be in a position to, comply with relevant obligations under the WRC it can make an application to Ofwat for a derogation.

The application form for derogations is appended to this guidance with the intention to allow electronic submissions via the Ofwat website.

2.1.1 Minimum requirements of a derogation application

A valid application should include as a minimum:

- **Details of the applicant** – full name and address of the Licensee or Appointee concerned and contact details of the person handling the request.
- **Derogation type** – as previously stated we have designed a process that allows an applicant to make a derogation specific to their company or if they are an integrated appointee and consider that there is a need for a temporary derogation to apply across all integrated Appointees this can also be applied for. Where a company feels a derogation should apply to all market participants, Ofwat would expect this to be proposed as a WRC change proposal via the code Panel.
- **Description of the derogation request** including the section of the WRC or subsidiary document to which the request applies and where appropriate the amendments to, or additional derogations required in, Schedule 8 to the MAC
- **An explanation of why the non-compliance is expected to occur** and detail of any /mitigating measures that have been put in place and what actions you are proposing to take to ensure compliance is restored as soon as is reasonably practicable.
- **A comprehensive assessment of the impact of the proposed derogation and non-compliance** which should include where possible qualitative and quantitative data of the impact of non-compliance. We require companies to consider the impact on their business, potential impacts on the market operator and potential impacts on customers.
- **Proposals and timelines for restoring compliance** – where possible these should include any contingency in timescales that may be required.
- **A description of how customer impact will be minimised**
- **A description of how the granting of this derogation would not unreasonably adversely affect competitors** this should include details on how this would affect level playing field requirements and how these would be mitigated.

- **Any additional information to support your request** including, in the case of a general derogation application, supporting information from other market participants.

Licensees and Appointees are advised to give as much notice as possible when making derogation requests since a derogation will not be granted unless Ofwat is satisfied that the request is justified. If we require further information or an application is incomplete, this will necessarily cause the timescale to be extended.

3. Assessment and consultation of a derogation request

Each derogation request will be assessed by Ofwat individually on its own merits and against the minimum requirements in paragraph 2.1.1 above.

In its assessment Ofwat will have regard to its statutory duties under the Water Industry Act 1991 and the Water Act 2014 and will always consider amongst other things the impact on:

- **Customers:** we will consider the extent to which non-compliance impacts on customers, for example through poor customer experiences. The application should demonstrate that it protects the interests of customers;
- **Competition:** for example, any competitive advantage gained by the grant of the derogation or distortion to the market that may arise from granting the derogation. This includes consideration of level playing field requirements;
- **Resilience:** how the request could affect the resilience of the Water and waste water services, environmental obligations and whether there would be any adverse effects on the functions and activities of each Licensee and Appointees and their ability to finance them;
- **Better regulation:** does the request align with Ofwat's duty to ensure that regulation is transparent, accountable, proportionate, consistent and targeted at cases where action is needed. There should be no significant risks or adverse impacts associated with the non-compliance to the Licensee or Appointee, or other relevant Licensees or Appointees; and no substantive objections from other parties, which would prevent Ofwat from granting the derogation;
- **Central systems and operations:** We will take into account the impact on the Market Operator's central systems if a derogation were to be granted and the consequent ability of other Licensees and Appointees to comply with their WRC and statutory obligations. Applicants should demonstrate there are no additional measures or reasonable options that could be taken (time and cost) to mitigate the non-compliance, which would otherwise remove the requirement for a derogation; and
- **Other parties affected:** we will seek the views of affected parties before making a decision, in particular the parties to s66D/117E Agreements with the applicant.

There should be no significant risks or adverse impacts resulting from the non-compliance to the Licensee or Appointee, other relevant Licensees or Appointees and no substantive objections from other parties, which would prevent Ofwat from granting the derogation.

Each submission must provide sufficient detail for Ofwat to make an assessment of the effect of a derogation. Where we determine that there is insufficient information for these purposes we will seek further information or clarification from the applicant.

3.1 Consultation

As part of the assessment process Ofwat may seek advice or comments from any affected parties including through the consultation process.

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. Parties must agree to the derogation as part of their existing contractual agreement for it to be granted.

In addition to any parties to relevant s66D/117E Agreements Ofwat reserves the right to consult other parties. These parties may include, but are not limited to:

- the Market Operator;
- Defra;
- The Welsh Ministers;
- other Licensees and Appointees;
- industry stakeholders, including the Drinking Water Inspectorate, Environment Agency, CCWater; and
- any independent party for expert assessment.

Consultation with any of the above parties will be at Ofwat's discretion bearing in mind the need for a timely process.

4. Ofwat's decision

If Ofwat considers that the derogation request is justified, it will send details of the proposed derogation to the Panel for further consideration. Following the decision to combine the WRC and Wholesale contract, Ofwat considers that a derogation which relates to the WRC as it applies to s66D/s117E Agreements is in effect a change to the WRC and as such should be considered as a change proposal to the WRC. As Schedule 8 to the MAC already contains derogations relevant to condition R4 of the Instrument of Appointment (the Stapling Condition), Ofwat considers that a derogation which relates to the WRC as it applies to the written arrangements between the wholesale and retail businesses of an integrated Appointee, as required by the Stapling Condition) is in effect a change to Schedule 8 to the MAC. As such, Ofwat considers that it too should generally be considered by the Panel.

Ofwat will have followed its derogations process before reaching a view that a WRC and/or MAC 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 code change such that it complements rather than duplicates the derogations process.

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 if any of the derogation on the central systems and the integrity of the WRC will be valuable. Recent changes to the Market Arrangements Code, make provision for Ofwat to set out the timetable for the Panel through the "Authority Timetabled Change" process. Once the Panel confirms there are no consequences for the central systems or the WRC in general, Ofwat will proceed to grant the derogation.

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 or Appointee need not comply and the expiry date of the derogation; together with the reasons for granting the derogation. 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 of these Wholesale Contracts as Schedule 4 and to publish the Direction on Ofwat's Website and place it on the Public Register.

If the applicant has also sought further amendments to Schedule 8 of the MAC either as a consequence of the main derogation application or as a separate application, then a further Direction will be issued setting out the modified Schedule 8 relevant to the applicant. The consequence of the issue of this Direction is that individual Appointees will have different versions of Schedule 8 applicable to them.

If Ofwat refuses a derogation request Ofwat may still consider whether enforcement action is appropriate in the circumstances.

4.1 Timeline

We will acknowledge receipt of a valid application within 30 business days. The derogation request will then be subject to Panel timescales, unless the Authority decides to use the Authority Change Process.

If further information is requested the time period will be adjusted (paused) to reflect the need for further information and providing a response.

5. Derogation transparency

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 placing all derogations granted in the Public Register and publishing on the Ofwat website.

This will provide everyone with an understanding of the nature of the derogations granted which in turn will inform any future arrangements market participants have with the Licensees or Appointees who have been granted derogations.

If a derogation has been granted in the past this does not mean any similar application will be granted in the future. Each application will be assessed on its own merits. However the existence of derogations in similar circumstances can be cited in support of an application, where applicable.

We recognise that evidence submitted during the application process may be of a commercially sensitive nature. Ofwat will consider the appropriateness of sharing such information when consulting affected parties, seeking the consideration of the Panel and also when providing the reasons for its decision.

5.1 Public Register

The Public Register on Ofwat's website will contain all of the WRC and Stapling Condition derogations that have been granted. In due course we will tag and categorise each application whether granted or refused to allow companies to access these quickly and easily.

We will also produce webpages that describe the process for applying for derogations in accordance with this guidance document. We will also make the application form available online.

6. Appendix: Derogation application form

Name of licensee _____

Address 1 _____

Address 2 _____

Address 3 _____

Town/city _____

Postcode _____

Date _____

Details of the derogation request

Reference to code document _____

Reference to WRC section _____

Reference to sub section _____

Version number _____

Link to document _____

What type of derogation are you applying for?

A specific derogation from the WRC as it applies to one or more Wholesale Contracts

A general derogation from the Stapling Condition

A specific derogation from the Stapling Condition

If you are applying for a general derogation from the Stapling Condition please provide details below of any other supporting parties. As a minimum supporting parties' contact details should be provided.

Area 1: Are you applying for a derogation as a specific derogation from the stapling condition or the WRC (applicable to you as an entity singularly) or for a general derogation from the stapling condition (applicable across all Integrated Appointees). You should include details of why you consider the derogation is specific or general.

Area 2: Description and supporting rationale as to why non-compliance would be expected to occur without the requested derogation. You should include details of any pre-emptive action or mitigation measure you have taken and what further action you are proposing to take to ensure compliance is restored as soon as is reasonably possible.

Area 3: A comprehensive assessment of the impact of the non-compliance. As outlined in section 4 of this guidance on the assessment and consultation of a derogation request, we will consider and so companies should include information on the range of items we outlined, which include the impact of the proposed derogation on:

- Customers
- Competition and level playing field
- Resilience
- Better regulation
- Central systems and operations
- Other parties affected

Area 4: Proposed period of the derogation a derogation will be granted for a defined period and may contain triggers to remove the derogation in certain circumstances. Please outline the period of the derogation you are requesting. In addition, as outlined in section 3 of the guidance please provide assurance that there are no additional measures or reasonable options that could be taken (time and cost to mitigate the non-compliance, thus eliminating or minimising the requirement for a derogation;

Area 5: Schedule 8 of the MAC

If the applicant is seeking a derogation which impacts on schedule 8 of the MAC, the effect should be outlined below:

Area 6: Any relevant additional information to support your request including, in the case of a general derogation application, supporting information from other market participants.

Area 7: Contracted parties

Please provide details of all parties to s66D/117E Agreements who will be affected by the proposed derogation. Ofwat will engage with these parties as part of its derogations assessment process.