

# Agenda

## Advancing economics in business

### Steady flow: evolution not revolution in the Water White Paper?

After four years of consultation, the UK government has published its Water White Paper. This proposes changes to the water resources and abstractions regime, and measures to increase competition in the sector—both shorter-term measures, and intentions that the government has left open for the longer term. Will the proposals solve water resource problems in the medium to longer term, particularly in the south-east of England, where hosepipe bans have just been announced?

In December 2011, the UK government published its Water White Paper, providing a road map for reform in the water sector in England.<sup>1</sup>

With short- and long-term plans for reform, the paper focuses on issues linked directly to the sustainability of water resources, including resources management and the abstractions regime. Another important component is water competition,<sup>2</sup> with a discussion surrounding the arrangements for licensing and markets, access pricing, and retail competition. For a number of the proposals, legislative change would be required.

What will the White Paper mean for the water sector in England going forward? Below, the market reform proposals are discussed first, before looking at the issue of water resources.

#### Evolutionary market reform

In seeking to increase the scope for competition in the water sector, the government states that it wishes to follow an 'evolutionary approach to reform [with] deregulatory changes to make the existing competition regime work more effectively'.<sup>3</sup> Many of the proposed changes reflect the recommendations of the Cave Review,<sup>4</sup> in particular those aimed at widening the scope for retail competition for non-domestic customers, as well as for certain forms of entry for new market participants upstream. These include creating a separate water supply licence for sewerage retail services; unbundling the water supply licence to allow scope for upstream-only entry; replacing the cost principle for access pricing; reducing the threshold for customer eligibility to switch retailer supplier under the water supply licensing (WSL) regime; streamlining the inset regime; and reforming the special mergers regime. Also, as per the Cave Review, the government

does not see a case in the foreseeable future for extending retail competition to households.<sup>5</sup>

One important difference, however, is that the White Paper has ruled out requiring the legal separation of water companies' retail businesses:

We will not introduce changes that risk unsettling investor confidence in the stability of the water sector, particularly at a time when new investment will be essential... The Government has therefore decided not to take forward the proposal for separation of the retail businesses of water companies that was proposed by the Cave review... [We] are adopting an evolutionary approach... which seeks to deliver benefits from increased competition while minimising costs to business and avoiding the risks and uncertainties linked to [separation]. We believe that a healthy competitive market... can be achieved without mandating separation of these businesses, and will instead reform the... WSL and inset regimes to deliver change in a lower risk way... We will introduce legislation at the first opportunity to implement these reforms.<sup>6</sup>

#### Retail reforms

Two key reforms for WSL retail competition proposed in the White Paper are the reduction of the eligibility threshold for non-domestic water customers, and the introduction of a retail licence for sewerage (see the following section).

The government has already introduced legislation to reduce the water non-domestic eligibility threshold from 50ML to 5ML per annum in England. In the White Paper, it proposes to reduce this threshold to zero

(although, as noted, it does not intend to extend retail competition to households).<sup>7</sup> Another important proposal in the White Paper is the plan to partner with the Scottish government to regulate the retail competitive market, to improve sharing of information and market codes, and to remove the need for double licensing of retailers.<sup>8</sup>

The White Paper also proposes that a requirement be introduced in primary legislation for Ofwat to produce statutory market codes that will set out the respective roles, duties and responsibilities of all market participants and sector regulators. This includes the development of standard terms and conditions for market contracts, which is expected to remove uncertainty surrounding negotiations between parties, and make customer switching simpler.<sup>9</sup>

## Portals for entry

The government also proposes that different WSL licences should be available to support entry at different points in the value chain, broadly reflecting the Cave Review recommendations.

First, as noted, a WSL retail licence would be created for sewerage services (WSL retail licences are currently restricted to water services). This would be accompanied by the introduction of WSL licensing for sewage treatment and disposal (mirroring the unbundled upstream licence for water, described further below).<sup>10</sup>

Second, the government notes that it would unbundle the current WSL combined licence, so that a new entrant wishing to provide upstream water services, such as securing a water resource and putting water into a company's system, would no longer be obliged to provide retail services as well.<sup>11</sup> This unbundled upstream licence might cover resources, storage and treatment, although there is some ambiguity as to its exact scope.

Third, particularly large customers might obtain a 'self-supply' licence, buying directly from the wholesale part of the incumbent water company and bypassing the need to use a retailer as a 'middleman'.<sup>12</sup>

Fourth, and in what seems to build on the existing 'inset' (or 'new appointments') regime, which rests outside the WSL framework, the government plans to introduce a 'network licence'. This would enable new entrants to own and operate infrastructure (mains, pipes, storage and treatment), which they would connect up to the incumbent's network, and use to provide water supply and sewerage services to their own customers and other new entrants.<sup>13</sup> This is akin to a new licence for third-party networks.

Taken together, the above portals mean that there could be *some form* of competition in virtually every part of the value chain. Retail WSL entry would involve final customers having a choice of their supplier, which would look more like competition *in* the market. In contrast, entry secured via a network licence looks like an extension of that which already occurs under the current inset/new appointments regime—in which an entrant can become the licensed appointee for a site (such as a new housing development), own the final-mile pipe infrastructure, and secure a bulk supply from the incumbent water company. This network licence entry looks more like competition *for* the market. In practice, new entrants would potentially include both incumbent water companies (across Great Britain) securing a new licence and operating out of area, and new entrants per se.

With these changes in place, precisely what the competitive landscape looks like will depend on which of the opportunities are most lucrative for entrants. The government is clearly not pressing for any one model here. Like the Cave Review, it is not pressing for fully fledged wholesale market competition. Instead, it seems to be hoping that, with a fairly comprehensive licensing system in place, and with the correct market rules and incentives, opportunities—at least some form of competitive landscape—will emerge. This is an evolutionary approach in the government's sense of the term.

## Access charging

Importantly, in an attempt to change the overall competitive landscape, the government wants to level the playing field by removing the costs principle from legislation in a future Water Bill and replacing it with a more transparent access pricing regime.<sup>14</sup> This principle was first set out in the Water Industry Act 1991, and it has affected access charging under both the inset and WSL regimes. Ofwat's interpretation is that the principle prescribes that access charges must be based on a specific form of 'retail-minus' access pricing, calculated as the incumbent's retail price minus 'Avoided or Reduced or Recovered in some Other Way' (ARROW) costs, *plus* the transactional expenses incurred in providing access. Ofwat regards this as an inflexible approach that has also limited the prospects for retail entry because it leaves small retail margins.<sup>15</sup> The approach (and Ofwat's interpretation of it) was also criticised by the Competition Appeal Tribunal in the Albion Water case.<sup>16</sup>

What the government wishes to see in legislation is a less prescriptive approach that would require Ofwat to set out an enforceable access charging methodology for the WSL and inset regimes. This would be a common regulated approach to access, removing the need for an entrant to negotiate access terms with each of the 21 incumbent water companies.<sup>17</sup>

The details of what an alternative access charging approach might look like still need to be worked out. Potentially, this could be based on a retail-minus or a 'cost-plus' approach (or on something else). Because the variety of licence reforms planned by the government (discussed above) would require access to different parts of the value chain, the access pricing approach may need to be general enough to cover all these potential portals. If this is not possible, a more specific set of access pricing rules for each part of the value chain may be required. In any event, water companies will, over time, need to revisit their access pricing methodologies, to ensure that they comply with both the specific sector rules as they emerge and with more general competition law.

## Sustainable water resources

Many of the measures in the White Paper relate much more directly to the issue of water resources. These include potential measures to reform the abstraction regime, examination of the scope for more interconnection and for bulk water transfers between companies, and improvements to the Water Resources Management Planning (WRMP) process.

On reforming abstractions, the government notes that much has yet to be decided:

We will introduce a reformed water abstraction regime resilient to the challenges of climate change and population growth and which will better protect the environment. We will work closely with stakeholders in designing the new system and will establish a national advisory group to guide the process. We plan to consult on proposals in 2013, and aim to introduce legislation to reform the regime early in the next Parliament.<sup>18</sup>

Issues that the government is considering include a better reflection of the scarcity and value of water in abstraction charges, and greater scope for abstraction trading in future. The government's intentions here should, as noted, become clearer in 2013.

In the meantime, a clearer steer is given by the government on certain issues. The White Paper states that the government will reduce the barriers to trading abstraction licences, and that the Environment Agency (EA) will improve market information, to make it easier for any willing buyers and sellers to see the value of their abstraction licences.<sup>19</sup> The government also recommends that the EA should pilot the use of reverse auctions to quickly restore catchments to sustainable levels at least cost. Under this mechanism, the EA would seek bids from different abstractors in a particular catchment area to sell back part or all of their licensed volumes to the Agency. The EA would then accept offers that deliver the best value in restoring

abstractions to sustainable levels.<sup>20</sup> These issues are still very much left for exploration, however—for example, the government is not actively pushing for the development of a fully fledged abstraction licence trading market, perhaps owing to the uncertainties involved.

The ball is also put into the EA's court on exploring the scope for increased interconnection in the south-east of England, building on work undertaken by Defra on technical barriers to water trading and interconnection. In particular, the White Paper notes that the EA will review interconnection options across all water supplies to provide a challenge to the companies' water resource management plans (WRMPs).<sup>21</sup> In tandem, the White Paper notes how Ofwat's proposals in its recent Future Price Limits (FPL) consultation could improve regulatory incentives for companies to import and export bulk supplies of water.<sup>22</sup> The government also plans to take account of its White Paper priorities when it issues guidance on how companies should approach their WRMPs.<sup>23</sup>

Nonetheless, much has been left open. In many cases, the government states that it will need to undertake further work with the EA and Ofwat before deciding on the appropriate approach. As noted, on other issues the EA has been left with the task of undertaking further analysis. Ofwat is then left to deal with other issues—for example, changing regulatory incentives to help stimulate bulk supply trades as part of the FPL.

## Competition or coordination?

An important question that follows is whether the proposed measures sum to a coherent strategy for dealing with water resources issues—particularly in the south-east of England. In an average year, this area is one of the most water-constrained regions of the UK, and the current drought situation in the area (and in East Anglia)—while being an infrequent and perhaps unavoidable event—certainly focuses the mind on thinking about these issues.

Much of the White Paper discusses how improving market signals and regulatory incentives, and reducing various barriers, could bring about change. This is also, broadly speaking, where Ofwat is coming from, as summarised in 'Valuing every drop', published in February 2012.<sup>24</sup> However, some of the White Paper proposals may emerge only in the longer term—if, indeed, they emerge at all (for example, abstraction licence trading).

Moreover, it is not clear that all the barriers to encouraging better allocation of water resources are being addressed. In particular, a key barrier to increasing bulk supplies is that water companies are responsible for the security of supply of their own

customers in their licensed areas, not the security of supply to customers in a neighbouring company's area to which they provide a bulk supply. In the south-east of England, for example, while a holistic approach to sharing water resources might be better for the region as a whole, it might not be individually optimal for each company. Better regulatory and market incentives to trade bulk supplies, as envisaged under Ofwat's FPL work, will help, but may not completely address this issue.

In the region, it is of note that the Water Resources South East (WRSE) Group has for a number of years been examining how a more holistic approach could be adopted, including the development of shared (rather than independent) new resources, and more use of bulk supplies.<sup>25</sup> However, the Group plans resources on a voluntary basis, not a mandatory one, and companies are not obliged to adopt the solutions that it identifies. While the EA and Ofwat are likely to take a dim view of companies that ignore the WRSE Group solutions—when the EA assesses WRMPs, and when Ofwat sets price limits—the question remains as to whether there should be more strategic planning of water resources in the south-east, and a more holistic approach to regional security of supply.

Interestingly, on the issue of strategic planning, the White Paper notes that:<sup>26</sup>

Government, the Environment Agency and the water industry will consider further whether there are strategic national infrastructure projects necessary to ensure water supplies remain resilient and, if so, whether there are barriers to delivery that should be removed.

At this stage, the government does not envisage that major new projects are required, as occurred

pre-privatisation. Rather, it claims that smaller-scale strategic interconnection projects, joining up supply zones within and between company networks, would be a better and more sustainable solution, in particular because of the uncertainty over which parts of the country will have surplus water in future.<sup>27</sup>

There remains, however, the issue of the most appropriate set of mechanisms to achieve even smaller-scale interconnections. The two examples provided in the White Paper are of interconnection projects undertaken by water companies within their own areas of supply to improve resilience, not projects involving the negotiation of interconnection and bulk supply agreements between independent companies.<sup>28</sup> The mechanisms to encourage interconnection are, in practice, likely to need to achieve an appropriate balance between competition and coordination, and between incentives and compulsion.

## Concluding thoughts

The publication of the Water White Paper is an important milestone in the reform of the water sector. The government emphasises that it is implementing evolutionary reform, which shares language similar to the 'step-by-step' approach proposed by both the Cave Review and Ofwat at the beginning of the reform consultation.

What remains unclear at this time is whether the proposed reforms to resources (some shorter-term; some undecided or left to the longer term) will be sufficient, or come in time to resolve ongoing issues, such as those in the south-east of England. In the meantime, the government will be undertaking further work with the EA and Ofwat on resources and abstractions issues, before deciding on the appropriate approach for the longer term.

- <sup>1</sup> Defra (2011), 'Water for Life', December. Note that reform in Wales will be decided by the Welsh government, which is expected to publish its water strategy paper during 2012.
- <sup>2</sup> The issue of competition reform is discussed more substantially in the supporting document to the White Paper: Defra (2011), 'Water for Life: Market Reform Proposals', December.
- <sup>3</sup> Defra (2011), 'Water for Life', December, para 5.32.
- <sup>4</sup> Cave, M. (2009), 'Independent Review of Competition and Innovation in Water Markets: Final Report', April.
- <sup>5</sup> Defra (2011), 'Water for Life', December, para 5.34.
- <sup>6</sup> *Ibid.*, paras 5.33 and 5.34. See also Defra (2011), 'Water for Life, Market Reform Proposals', December, para 1.4. 'We have decided not to introduce fundamental structural change to the industry such as requiring legal separation of water companies' retail functions. We do not want to take risks with a successful model given the challenges we face in building the resilience of the sector.'
- <sup>7</sup> Defra (2011), 'Water for Life', December, para 5.35.
- <sup>8</sup> *Ibid.*, paras 5.36 and 5.37.
- <sup>9</sup> *Ibid.*, para 5.38.
- <sup>10</sup> *Ibid.*, para 5.39.
- <sup>11</sup> *Ibid.*, para 5.47.
- <sup>12</sup> *Ibid.*, para 5.43.
- <sup>13</sup> *Ibid.*, para 5.49.
- <sup>14</sup> *Ibid.*, para 5.41.
- <sup>15</sup> See Ofwat (2009), 'Ofwat's Response to the Cave Review on Competition and Innovation in the Water Markets', June; and Ofwat (2009), 'Ofwat's Response to the Consultation on the Cave Review of Competition and Innovation in Water Markets', December.
- <sup>16</sup> The Competition Appeal Tribunal ruled that, in this case, the approach led to an anti-competitive margin squeeze. See Competition Appeal Tribunal (2006), 'Albion Water Limited & Albion Water Group Limited v Water Services Regulation Authority (Dŵr Cymru/Shotton Paper)', Judgement, Case Number 1046/2/4/04, October 6th.
- <sup>17</sup> Defra (2011), 'Water for Life', December, para 5.37.
- <sup>18</sup> *Ibid.*, p. 20.
- <sup>19</sup> *Ibid.*, paras 3.43 and 3.44.
- <sup>20</sup> *Ibid.*, para 3.38.
- <sup>21</sup> *Ibid.*, para 2.25.
- <sup>22</sup> *Ibid.*, para 2.26.
- <sup>23</sup> *Ibid.*, p. 46. Defra and the EA have since (in February 2012) published for consultation some amendments to the WRMP guidance. See <https://consult.environment-agency.gov.uk/portal/ho/waterres/draft/plans>.
- <sup>24</sup> Ofwat (2012), 'Valuing Every Drop: How can we Encourage Efficiency and Innovation in Water Supply?', focus report, February.
- <sup>25</sup> See Water Resources in the South East Group (2010), 'Progress towards a Shared Water Resources Strategy in the South East of England, Summary Report', April.
- <sup>26</sup> Defra (2011), 'Water for Life', December, p. 46.
- <sup>27</sup> *Ibid.*, paras 2.23 and 2.24.
- <sup>28</sup> *Ibid.*, para 2.24.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email [l\\_mautino@oxera.com](mailto:l_mautino@oxera.com)

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