

Agenda

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The Water Bill: a turning point?

In June 2013, the UK government published the Water Bill, outlining its plans for the water sector in England and Wales. It proposes a number of reforms of the sector in areas such as competition, resilience and water resource availability. What are the key provisions of the Bill, and how might they affect the future of the UK water industry?

The UK government's Water Bill puts forward a number of provisions that will affect the water sector in England and Wales.¹ The Bill evolved from the government's vision for the water industry, as set out in the December 2011 Water White Paper.²

The Water Bill paves the way for a number of reforms of the sector, including:

- introducing retail competition for non-household customers;
- improving the resilience of the sector, and the availability of water resources;
- preparing for the development of some form of competition in wholesale water activities (ie, upstream competition);
- a number of other reforms, such as reform of the merger regime.

Retail reforms

An important reform included in the Bill is the introduction of retail competition for non-household customers in England. As a first step towards introducing retail competition for all non-household customers, the Water Bill gives the Secretary of State in England the power to remove the current threshold (of 5m litres of water per year) for non-household customers who are eligible to switch supplier.³ Similarly, the Welsh Assembly government will be able to decide on the eligibility threshold in Wales (currently, 50m litres of water per year).⁴

In its response to the House of Commons Environment, Food and Rural Affairs (EFRA) Select Committee, the UK government reiterated its intention to open the retail market for all non-household customers in England in April 2017.⁵ The Welsh Assembly government, however, is yet to decide on whether it will change its current threshold.

The retail market envisaged in England will therefore be more akin to that which currently exists in Scotland, where all non-household customers are already able to switch supplier.⁶ Indeed, the Water Bill aims to create a retail market that crosses the border between England and Scotland. To cater for this cross-border market, the Bill includes provisions to enable Ofwat, the economic regulator of the water industry in England and Wales, and the Water Industry Commission for Scotland (WICS) to accept a single application for a water and sewerage retail licence in each other's jurisdiction.

As per the draft Water Bill and the White Paper, the Water Bill does not allow for the legal separation of the incumbent water company's non-household retail activities. This is different from the way that non-household retail competition was established in Scotland, where the incumbent water company, Scottish Water, went through a legal separation of its non-household retail activities from the rest of its wholesale activities. This aimed to ensure that its non-household retail activities are at 'arm's length' from the wholesale business, and to provide a level playing field for new entrants to the non-household retail market.

To help create a level playing field in England, the EFRA Select Committee recommended a mandatory functional separation of non-household retail activities.⁷ In its response to the Select Committee, however, the government explained that:

Given the size and diversity of the water industry in England and Wales, we do not think it would be appropriate for the Government to prescribe any model on the face of primary legislation that will be difficult to change as water markets evolve – including functional separation of incumbents' retail functions.⁸

Also in this issue, 'The clock starts now: customer choice in the retail water market' presents the views of Alan Sutherland (WICS) and Sonia Brown (Ofwat) on what may happen to the sector in England in 2017.

To ensure a level playing field in England, therefore, the onus will instead be placed on the incumbent companies and Ofwat. The incumbent companies will have to demonstrate that they are not treating their own retail arms any differently from how they treat other retailers. Ofwat and the wider industry will have to develop market codes to govern the relationship between the incumbent companies and the retailers. Ofwat will then police the markets using the powers provided in the Bill, including taking enforcement action where charging rules or market codes are breached.

Another consequence of not allowing legal separation is that incumbent water companies will be unable to exit the non-household retail market voluntarily. Indeed, the EFRA Select Committee recommended that a provision be included in the Bill to allow companies to exit.⁹ However, the government rejected this recommendation, believing that it would leave it open for a competition authority to impose separation on the sector, rather than this being a decision left to Ministers. Instead, the government suggests that water companies could consider establishing a joint venture with other incumbents or new entrants as a way of avoiding a scenario in which an incumbent company has to prop up inefficient retail operations.

As such, the Water Bill aims to provide the flexibility necessary to introduce retail competition for all non-household customers. Much of how the retail market operates in practice, however, will depend on the detail, which is yet to be developed in an 'Open Water' programme for reform.¹⁰ This includes details of the relevant industry codes, and other market arrangements.

Improving resilience and the availability of water resources

The Water Bill aims to improve the resilience of the industry, and the availability of water, through a number of mechanisms.

First, the Bill includes reforms covering bulk supply trading between incumbent water companies. It amends the Water Industry Act 1991 to give Ofwat more flexibility to determine what should feature in bulk supply agreements, by providing the regulator with the power to introduce codes and charging rules for bulk supplies. It appears that these reforms are to increase the level of interconnectivity across company areas by enhancing transparency, and to streamline negotiations between undertakers (including new appointees).

Arguably, these reforms would interact with the regulatory regime for bulk water trading being considered by Ofwat in setting price limits for 2015.¹¹ In this, Ofwat is proposing incentives for both importers and exporters of water.

Second, this focus on resilience is consistent with the measure recommended by the EFRA Select Committee to elevate the current sustainable development duty to become a primary duty for Ofwat. Rather than changing this duty, however, the government has proposed a new overarching primary duty to secure the long-term resilience of water supply and sewerage systems against environmental pressures, population growth and changes in consumer behaviour, including through investment but also through managing water resources and reducing demand. This is designed to clarify the role of the regulatory framework in securing the long-term resilience of water and sewerage services. However, what the new resilience duty means in practice for the regulation of the water industry is not yet clear.

The original White Paper set out an array of reforms to the abstraction licensing system. However, while this would require further primary legislation in due course, these reforms are not being pursued in the Bill; instead, the government is 'focussing substantial resources on developing abstraction reform options', which will lead to a consultation paper being published later in 2013.¹²

Upstream reforms

As regards upstream competition, the EFRA Select Committee was concerned that the case for reforms had not been fully made, and that more work was required on how upstream reforms could be introduced in a way that preserved investor confidence, protected customers, and maintained resilience. It wanted the Bill to state clearly the principles that would underpin the introduction of upstream reforms, including that there would be no further de-averaging of charges. The EFRA Select Committee also wanted the Bill to set target dates for the decision on the form and scope of upstream reforms, and for the opening of the upstream market.

However, the government is of the view that setting a blueprint for upstream markets through primary legislation would be self-defeating, and that, in any case, this should be for Ofwat and the market participants to determine. In addition, there are strong parallels between upstream reforms and abstraction reforms. The government states that, in any event, the upstream market would not open before 2019.¹³

The coverage of upstream competition in the Water Bill is therefore general in nature, leaving many of the specific details to be decided.

One change from the draft Bill is that the scope of upstream entry has been narrowed. While new upstream licences are proposed as per the draft Bill (under 'wholesale' and 'supplementary' licences), 'network infrastructure' and 'retail infrastructure' licences are not (the latter of these would have replaced the new appointments licences and variations

licences). The removal of network infrastructure licences was in response to the 'small' risk of stranding of assets and fragmentation of networks. In addition:

These changes narrow the scope for upstream entry to reinforce our commitment to incumbent water companies retaining ownership of the core network and responsibility for its ongoing management. The changes also focus reform more closely on our priorities of allowing new water resources and treatment to be introduced and stimulating alternative markets for recycled wastewater and sludge.¹⁴

Furthermore, the retail infrastructure licence, which would have replaced the current inset (or new appointment variations) regime, has also been removed since the draft Bill. Instead, the government will work with Ofwat to improve the inset regime.

The Water Bill sets out that any access charges would need to be based on rules published by Ofwat, which, in turn, would need to be based on guidance issued by Ministers. To alleviate some concerns expressed by the EFRA Select Committee regarding charging principles, the Ministers' guidance would be subject to parliamentary scrutiny.¹⁵ This appears to be aimed at mitigating some of the issues regarding the de-averaging of charges, which was a concern of the EFRA Select Committee.¹⁶

At this stage, the form of upstream competition that is envisaged is unclear. Network licences (a form of competition for the market) have been removed, but whether the remaining licences would be in the form of 'competition for the market' or 'competition in the market' is not clear. Instead, the Bill allows for flexibility to fit around more specific models that policy-makers, Ofwat and participants will need to determine at some future point.

Merger reform

The water sector has a particular merger regime, in which Ofwat refers to the Competition Commission mergers that are above a certain turnover threshold. The government regards this approach as a disincentive against mergers.¹⁷

An important part of merger assessment in the water sector is to consider the detriment incurred from the loss of a comparator. The Bill amends the Water Industry Act to require Ofwat to publish a statement of

methods on how it would assess the loss of a comparator. It also allows the Competition and Markets Authority (CMA) to determine whether to make a merger reference or to accept undertakings to compensate for the loss of a comparator in lieu of a reference.¹⁸ This determination is to be based on an initial assessment, including of Ofwat's application of its methods.

The Bill also includes a duty on the CMA to keep the merger turnover threshold under review (the threshold is currently set at £10m turnover, where the acquiring undertaker, the target undertaker or both undertakers together meet or exceed this threshold).¹⁹

The future?

Following its first reading, the Water Bill will now go through more readings in the House of Commons, and will then go to the House of Lords. The precise timescale is uncertain. In the meantime, the debate in the sector is set to continue. Importantly, any new regime will need to dovetail with Ofwat's approach to regulation, which will culminate in new price limits and accompanying incentives being set in 2014. In particular, there are important interactions with Ofwat's price-setting proposals for non-household customers, and the bulk supply import/export incentives, for example.

Going forward, Ofwat will have a primary duty towards resilience. This may not mean simply more capital expenditure by companies, but the right balance between operating and capital solutions to create more resilient and future-proof networks. There are interactions here with the total expenditure (TOTEX) approach put forward by Ofwat in its recent methodology consultation statement,²⁰ although the exact interpretation that will be taken of the duty is unclear.

In the meantime, there is much work to be done by companies in England to prepare for retail market opening to non-household customers in 2017. More work is also required on deciding on the most appropriate forms of upstream markets. Improving the market for bulk supplies between existing incumbents is a form of upstream market (without entry). The market for organic waste to produce electricity is also developing, which leaves open the question of what further upstream markets might then also be introduced or emerge in water.

- ¹ HM Government (2013), 'Water Bill', June 27th; and HM Government (2013), 'Water Bill: Explanatory Notes', June 27th.
- ² Department of the Environment, Food & Rural Affairs (2011), 'Water White Paper: Water for Life', December. Following this White Paper, in July 2012 the government published a draft of the Water Bill. Many stakeholders responded to the Bill's proposals—most notably, the House of Commons Environment, Food and Rural Affairs (EFRA) Select Committee provided several recommendations on changes to the draft Bill. See House of Commons Environment, Food and Rural Affairs Committee (2013), 'Draft Water Bill: Sixth Report of Session 2012-13', January. Some of its recommendations have been taken on board in preparing the Water Bill.
- ³ Ofwat (2013), 'Water Supply Licensing', available at <https://www.ofwat.gov.uk/competition/wsl/>, accessed on July 7th 2013. The threshold of 5m litres is set out in Ofwat (2011), 'Water Supply Licensing – Guidance on Eligibility', September.
- ⁴ HM Government (2013), 'Water Bill Explanatory Notes', June, p. 38.
- ⁵ HM Government (2013), 'Government Response to the EFRA Committee's Pre-legislative Scrutiny of the Draft Water Bill', June, p. 12.
- ⁶ Some background to the non-household retail market, which opened in Scotland in April 2008, is available in Water Industry Commission for Scotland (2011), 'Information Note 6: an Overview of the Competitive Retail Market', March.
- ⁷ House of Commons Environment, Food and Rural Affairs Committee (2013), 'Draft Water Bill: Sixth Report of Session 2012-13', January, p. 11.
- ⁸ HM Government (2013), 'Government Response to the EFRA Committee's Pre-legislative Scrutiny of the Draft Water Bill', June, p. 10.
- ⁹ House of Commons Environment, Food and Rural Affairs Committee (2013), 'Draft Water Bill: Sixth Report of Session 2012-13', January, pp. 11 and 12.
- ¹⁰ Information about the Open Water programme is available from Ofwat's website, <https://www.ofwat.gov.uk/openwater>, accessed July 11th 2013.
- ¹¹ Ofwat (2013), 'Setting Price Controls for 2015-20 – Framework and Approach', January.
- ¹² HM Government (2013), 'Government Response to the EFRA Committee's Pre-legislative Scrutiny of the Draft Water Bill', June, p. 16.
- ¹³ *Ibid.*, pp. 13–14.
- ¹⁴ *Ibid.*, p. 14.
- ¹⁵ HM Government (2013), 'Water Bill', June 27th, pp. 93–111; and HM Government (2013), 'Government Response to the EFRA Committee's Pre-legislative Scrutiny of the Draft Water Bill', June, p. 14.
- ¹⁶ House of Commons Environment, Food and Rural Affairs Committee (2013), 'Draft Water Bill: Sixth Report of Session 2012-13', January, p. 16.
- ¹⁷ HM Government (2013), 'Water Bill: Explanatory Notes', June 27th, p. 2.
- ¹⁸ As of April 2014, the CMA will replace the UK Office of Fair Trading and Competition Commission.
- ¹⁹ HM Government (2013), 'Water Bill: Explanatory Notes', June 27th, p. 2.
- ²⁰ Ofwat (2013), 'Setting Price Controls for 2015-20 – Framework and Approach', January.

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

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- price pressure in UK merger control: a retrospective *Chris Walters*
- the clock starts now: customer choice in the retail water market
Alan Sutherland, Water Industry Commission for Scotland, and Sonia Brown, Ofwat
- the EU draft Damages Actions Directive: another rebuttable presumption to rebut?

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