

**Consultation on the Cave Review of competition and innovation in water markets**

Defra consultation

Water UK response

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## **1. Introduction**

1. Water UK represents the main statutory UK water and wastewater service suppliers at national and European level. We provide a positive framework for the water industry to engage with its customers, water consumers, government, regulators and stakeholder organisations.
2. In this response to the joint UK and Welsh Assembly Governments' consultation on the Cave Review on competition and innovation in water markets, we report the shared views of UK water operators on the strategy Government should follow in extending competition in the water sector. As the consultation essentially concerns competition in England, this is the area to which our response generally applies for the time being.
3. We do not discuss the separate consultation questions as water companies will respond individually with their specific perspectives and discuss their views with Defra directly. Water UK will be happy to facilitate collective exchanges and meetings between Defra and our members. Such meetings would give Government officials opportunities to explore the range of our members' views on the various questions in the consultation. Also, they could be an opportunity to explore how the different competition regimes across the UK might affect customers that operate in all parts of the country.

## **2. Evolution through a phased approach**

4. It is now twenty years since privatisation and the water industry accepts that its model needs to evolve if it is to continue to be as successful as it has been so far. Growing expectations from consumers and society – ranging from better customer service to enhanced environmental protection and adaptation to climate change – require that the industry adapts its strategies and methods of working. The extension of competition is one of the mechanisms that could contribute to this evolution.
5. The process whereby competition is extended will be crucial. It is widely accepted that competition is a discovery process and it is not possible to predict the forms that competition will take past the initial stage. We are pleased that this inherent – and some say essentially constructive – uncertainty has been recognised by the

Cave Review and the Government in its present consultation. Both insist that a step-by-step or phased approach is the appropriate way to proceed.

### **3. An accountable governance framework**

6. As no one can predict the eventual shape that water competition will take – in the same way as competition in other sectors is a perpetually re-invented model - the crucial role for Government now is to create a strong governance framework that supports a phased approach to water competition. This view is supported by the experience of introducing competition in other sectors, which confirms that a strong governance framework is essential to take the industry forward decisively.
7. The main principle which should be used in determining a governance suitable for the introduction of competition in the water sector is that there must be democratic accountability for the way the water sector develops. Good governance of competition will have a very direct impact on business and domestic customers. A specific regime of statutory governance must therefore be determined by Parliament. Together with licences (or instruments of appointment) for all competitors and arrangements for market operations, such statutory guidance would remove the need for the non-statutory guidance currently operated by Ofwat.
8. The industry strongly believes that broad enabling powers for Ofwat to introduce competition will not provide adequate governance, will increase regulatory risk and, thereby, increase the cost of extending competition unnecessarily.

### **4. A role for Parliament**

9. The industry, therefore, thinks that Parliament should make specific provisions for a governance framework which include:
  - A statement of the objectives of competition – including that it must be efficient; these objectives should also apply to the inset appointment process
  - A provision that, in furthering competition, Ofwat must at all times have regard to its Section 2 (of the Water Industry Act 1991) duties and to Parliament's objectives for water competition

- A provision that customers not in the competitive market – including all household customers – should not pay more than they would otherwise pay; The Government has stated in its response to the EFRA Committee report on PR09 that it ‘recognizes that household customers must be protected from additional costs resulting from the creation of an effective retail market for non-household customers.’
- Clear principles and market rules to replace the current Section 66E of the Water Industry Act 1991 on the costs principle; the objective of these principles and rules should be that access prices (prices paid by water undertakers – new entrants or existing ones - for use of others’ infrastructure) fully support Government’s objectives for competition and, in particular, ensure that customers not in the competitive market pay no more than they would otherwise (see above).
- A specific description of how the water industry should be re-structured; this means, in practice, that Parliament should determine the new licences (instruments of appointment) which allow the implementation of the principle of retail separation
- A duty on Ofwat to take forward the introduction of competition by involving and engaging the water industry and other regulators fully – this duty to apply to future forms of competition as well as existing ones
- A provision that relevant regulatory changes made by Ofwat are implemented – after full engagement of stakeholders – only by means of modifications to individual company licences or instruments of appointment. These should be subject to the usual safeguard (appeal mechanisms, etc). It should not be possible to modify licence conditions indirectly and without safeguard by modifying non-statutory guidance which a licence condition gives water companies an obligation to follow
- A provision which sets up a specialised market management structure run by actual market participants – learning from the Scottish experience - distinct from Ofwat, which would have a role as an appeal body only.
- An obligation on Ofwat to ensure that the costs of setting up agreed market arrangements are recognized in the price setting process.
- A provision that ensures that failure by a market participant does not have negative consequences for any of the industry’s customers

10. An appropriate statutory framework would ensure that Ofwat's actions are designed to minimise the costs and disruptions of introducing competition and fully take into account water companies' obligations – regarding drinking water quality and the environment, for instance – and the objectives of the other industry regulators.

## **5. Market arrangements**

11. The Competition Act may prevent market participants from acting cooperatively – for instance the very important process of setting standard terms in access contracts might be seen as anti-competitive and not in customers' interests. It might then be necessary for Ofwat to take a lead. It should engage the industry, incumbents and new entrants alike, in developing contracts between all parties that covered the terms, including price terms, under which existing statutory water companies provide services to other parties – or, more generally, where one market participant provides services to another. Such services, for instance, include the provision of wholesale water or waste water services as well as access to networks. Generic contracts developed collectively would always need to be supplemented by specific provisions according to the characteristics of each case.

12. The market arrangements referred to above should, essentially, deal with commercial and operational issues under agreed market governance. Issues to be addressed would include: customer switching, settlements between market participants, treatment of customer debt, meter-related matters, etc. In particular, when the water market is widened to an increasing number of customers, market arrangements need to be reviewed by market participants to ensure that the customer transfer methods are adapted and stay fit for purpose. Ofwat must have a duty (noted above) to include the resulting costs in its price review process.

## **6. Minimising the impact of participant failure**

13. More work is needed to develop appropriate mechanisms to deal with a situation when a market participant fails. Failures by market participants is an inevitable outcome of competition – some commentators would describe failure as a healthy process – but our members are agreed that customers must not be seriously inconvenienced by it. At the same time, the cost of failure must be

minimised so that customers not involved in the situation do not bear its costs. Also, it is important that failure should not bring water competition or the water industry into disrepute.

14. It is therefore essential thoroughly to plan how to deal with failure before it happens. Solutions include the provisions of 'supplier of last resort', which some of our members support, the 'strategic supplies' provisions in the 1991 Act (but we and Defra understand that they are flawed as they are currently written) and other measures. We invite Defra to engage with the industry as a matter of some urgency to identify solutions.

### **Water UK – December 2009**

#### **More Information:**

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