

White paper on reform of water markets published

On 8 December 2011, the Department for Environment, Food and Rural Affairs (DEFRA) published a white paper setting out wide-ranging proposals for reform of the water industry (Water White Paper).

Introduction

The Water White Paper sets out DEFRA's conclusions on a series of reviews carried out in recent years which made a number of recommendations for reform, including the Walker Review on charging for household water and sewerage services, the Cave Review on competition and innovation in the water sector, and DEFRA's independent review of Ofwat led by David Gray.

The exact timing of the majority of the reforms set out in the Water White Paper is currently uncertain. Further detail will be provided when the government publishes a draft Water Bill in early 2012.

Competition in the water sector

DEFRA intends to introduce a number of deregulatory legislative changes with a view to making competition in the water sector work more effectively. DEFRA has decided not to introduce any fundamental structural changes and has rejected proposals put forward in the Cave Review which would have required the legal separation of water companies' retail operations. Nor will DEFRA introduce any legislation in the foreseeable future to open up competition in the household market.

The proposals concentrate instead on the supply of water to business customers, setting out intended reforms to the existing regimes for water supply licences and inset appointments. DEFRA has concluded that the water supply licensing regime, which was introduced by the Water Act 2003, has not worked well, with legislative barriers making the retail market unattractive to new entrants, and therefore sets out the following reforms designed to encourage new entry:

- The establishment of a new retail market for water and sewerage services in partnership with the Scottish government, enabling Ofwat and the Water Industry Commission for Scotland to mutually recognise each others' licensees. This would enable water and sewerage suppliers to compete for customers across England and Scotland.
- A reduction in the water consumption threshold for non-household premises in England to be eligible to be supplied by a water supply licensee from the current threshold of 50 megalitres per annum, initially to 5 megalitres and eventually to

Key proposals reflected in the Water White Paper include:

- Reforms aimed at enhancing competition in the supply of water to non-domestic customers.
- Increasing the turnover threshold for the application of the special merger regime for water companies to £70 million and allowing water companies to agree undertakings in lieu of a reference to the Competition Commission.
- Measures to allow water companies to offer more support to customers at risk of affordability problems.
- The long term replacement of the current regime for management of water abstraction and consideration of water trading and new proposals to deal with restoration of unsustainable abstractions.

zero. Draft Regulations (which are subject to Parliamentary approval) have already been published to reduce the threshold to 5 megalitres and are expected to come into force by the end of this year.¹

- The extension of the water supply licensing regime to cover sewerage services.
- The introduction of a new regulated approach for market entry. DEFRA proposes to remove the need for new entrants to negotiate terms with each of the incumbent water companies across England, as well as the need for water supply licensees to set up ring-fenced limited companies to qualify for a licence. DEFRA also intends to remove the in-area trading ban which currently prevents a water supply licensee set up by an existing water company from supplying water in the same area as the existing company.
- The introduction of a transparent wholesale access pricing regime for water supply licensees and inset appointees which removes the current costs principle, in order to reduce the risk of discriminatory pricing.
- The unbundling of the combined water supply licence so that a new entrant wishing to provide upstream water supply services will no longer be obliged to also provide retail services, and the extension of new entrants' access rights to include incumbent water companies' treatment and storage systems rather than just the mains and pipes.
- The introduction of two new types of licence: (i) a "network licence" enabling new entrants to own and operate their own infrastructure (mains, pipes, storage and treatment) which is connected to an incumbent's network and used to provide water supply and sewerage services to its own customers and other new entrants, and (ii) a "self-supply" licence enabling suitably qualified customers to become their own new entrant, buy water direct at wholesale prices and reduce the need to use a water supply licensee.
- Ofwat, together with other regulators and market participants, will be required to establish statutory market codes to increase transparency and set clear rules and timetables to help markets run more effectively and efficiently.

The water merger regime

DEFRA intends to amend the special merger regime in place in the water sector, which currently requires the Office of Fair Trading to refer mergers or proposed mergers between two or more water companies to the Competition Commission where the turnover of either the target or acquiring water company exceeds £10 million. A two-tier referral system will be introduced to allow companies to offer undertakings (including maintaining separate price controls or divestments) in lieu of a referral where the threshold is met. In addition, DEFRA is "strongly minded" to raise the current turnover threshold to £70 million, and will consult with water companies and others on this proposal.

In its ancillary market reform proposals, DEFRA has indicated that it will require Ofwat to publish its methodology on how it values individual comparators to assist acquiring water companies determine what undertakings they may be required to give, and that it will exempt inset appointees from the special merger regime.

Affordability and metering

The Flood and Water Management Act 2010 contained provisions allowing water companies to offer lower charges to groups of customers who have difficulty paying their water bills in full, and requiring the Secretary of State to publish guidance on the factors to be taken into account by companies in England in deciding whether one group of customers should subsidise another. Draft guidance was published in October 2011, and DEFRA has committed in the Water White Paper to publishing final guidance in early 2012, giving water companies time to design schemes in order to introduce social tariffs from April 2013 (where they choose to do so).

¹ The draft Water Supply (Amendment to the Threshold Requirement) Regulations 2011.

DEFRA also wants water companies to do more to actively promote metering to customers that would benefit, and to make switching as simple as possible for those that choose to do so. However DEFRA has confirmed that it has no plans to impose a blanket approach to metering across the country, and believes water companies are best placed to find the appropriate local solution in discussion with customers.

In recognition of the fact that customers of South West Water face the highest water bills in the country, DEFRA has decided to fund the company to enable it to cut bills by £50 per year for all household customers from April 2013 until at least the end of the next spending review. The high bills in the south west reflect the significant investment programme undertaken by South West Water since privatisation to raise sewerage standards in the region.

Water abstraction, water efficiency and sustainability

DEFRA intends to replace the current regime for managing the abstraction of water from rivers and aquifers, with a view to ensuring the regime is resilient to the challenges of climate change and population growth. A major focus of water abstraction reform is to encourage efficiency in the use of water. DEFRA will seek to do this, in particular, by ensuring that the reformed regime reflects the value of water to customers and its scarcity. DEFRA plans to consult on detailed proposals for reform in 2013, and aims to introduce legislation early in the next Parliament. A step-change approach is envisaged, starting with catchments facing particular risks of increased water stress, with the new regime not expected to be fully in place until the mid to late 2020s.

DEFRA sees further potential for water efficiency and water availability through increasing the possibilities for trading of abstraction licenses (water trading is a concept that has been developing in a number of countries²). Limited trading occurs currently and there are perceived to be a number of barriers to such trading including complex and uncertain rules. The Environment Agency will consider how it can encourage a more developed market in trading of abstraction licences. In particular, large unused licences could be revoked where a user does not reasonably need them.

The Environment Agency is also considering how bulk trading between suppliers could be facilitated by increasing the inter-connectivity of water supplies (e.g. through rivers and canals). This will complement work being carried out by Ofwat in relation to the water trading market.

Whilst reform of the abstraction system is intended to secure sustainable water supplies for the future, through implementation of the European Water Framework Directive, the Environment Agency has been considering the legacy of past unsustainable abstractions. Whilst this legacy is already being addressed gradually under the Agency's Restoring Sustainable Abstraction (RSA) programme, DEFRA proposes that water company solutions for restoration should be included in companies' Water Resources Management Plans and then in the price review process. DEFRA will now work with the Agency and Ofwat to develop these proposals.

Next steps

DEFRA will publish a draft Water Bill for pre-legislative scrutiny in early 2012 and introduce a Water Bill as soon as Parliamentary time allows. DEFRA will also publish its final guidance on social tariffs and will put in place new arrangements to work with stakeholders on the design of a new abstraction regime early in 2012.

In addition, DEFRA expects to produce a new strategic policy statement for Ofwat and social and environmental guidance during 2012. The new strategic policy statement will set out the policy framework within which Ofwat will use its regulatory powers to deliver the longer term goals set out in the Water White Paper.

² See our client briefing "[Tackling Water Scarcity – Water Trading Concepts and Possibilities: October 2011](#)".

Contacts

If you would like to know more about the subjects covered in this publication or our services, please contact:

Jenine Hulsmann +44 (0)20 7006 8216

Nigel Howorth +44 (0)20 7006 4076

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK

www.cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance LLP 2011

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh.