Department for Environment, Food and Rural Affairs

Water Bill

The structure and regulation of the water industry

November 2013

This is one of a series of briefing notes on the Water Bill. This note explains the current structure of the water industry and the way in which it is regulated in England and Wales. Further detail on the Water Bill can be found in other briefing notes

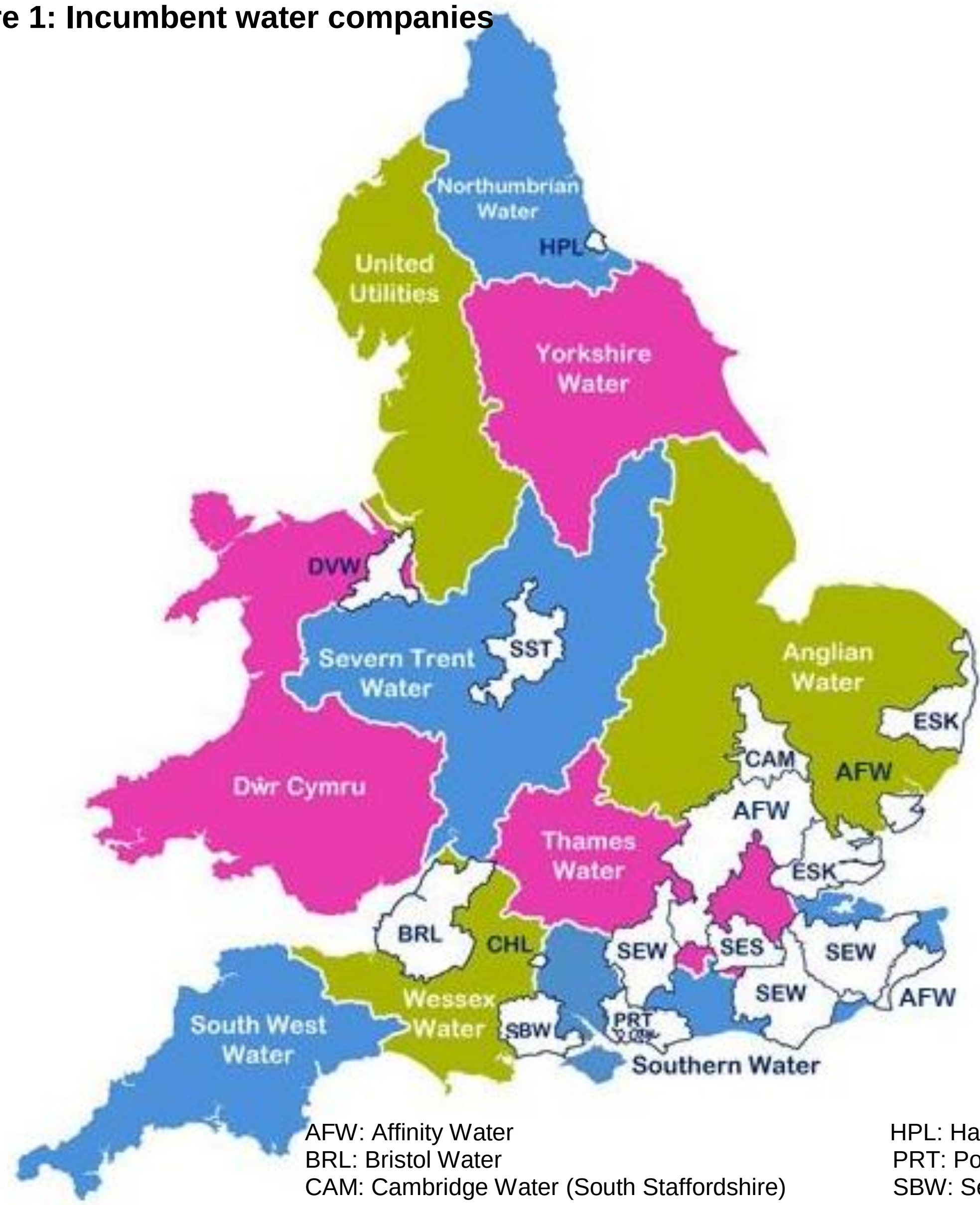
Contents

Introduction

This note explains the current structure of the water industry and the way in which it is regulated in England and Wales. The Water Bill will provide a new framework for competition that the UK Government believes will increase resilience, improve customer choice and support economic growth. However, given that a limited form of competition is already allowed, the market reform provisions in the Bill focus primarily on removing barriers to competition and improving the functioning of the market, rather than significantly altering its underlying structure or regulation.

For further information about the detailed changes that the Water Bill will make to the water industry, please refer to other briefing notes produced alongside this background note.

Figure 1: Incumbent water companies



AFW: Affinity Water
BRL: Bristol Water
CAM: Cambridge Water (South Staffordshire)
CHL: Cholderton & District Water
DVW: Dee Valley Water
ESK: Essex & Suffolk (Northumbrian Water)

HPL: Hartlepool (Anglian Water)
PRT: Portsmouth Water
SBW: Sembcorp Bournemouth Water
SES: Sutton & East Surrey Water
SEW: South East Water
SST – South Staffs Water

Structure of the water industry

Incumbent water companies

The water industry was privatised in 1989 when the water supply and sewerage functions of 10 publicly-owned regional water authorities were transferred to limited companies. There are now 19 licenced “incumbent” water companies across England and Wales: 10 water and sewerage companies and 9 water-only companies (see Figure 1). Each company is appointed by Ofwat and holds a regional monopoly for providing water and sewerage services in a particular geographical area.

Privatisation of the water industry has been successful in attracting over £116 billion of investment in incumbent water companies.[1] This investment is used to maintain and upgrade their infrastructure (for example pipes, reservoirs and sewerage treatment works), improve the water environment and to produce cleaner, safer water supplies. Without this investment, water companies would need to collect all of the money needed to upgrade the infrastructure from their customers, which would make bills around a third higher than they currently are. Water companies would also have to collect money from customers in the year that they spend it on a “pay as you go” basis, which would make bills more volatile from year to year.

The Government places a high priority on ensuring that the water sector continues to remain attractive to investors, whose investment will continue to be an important tool in helping to keep bills affordable. We need to encourage greater innovation and efficiencies alongside this investment, and to deliver it without undermining the reputation for stable regulation which attracts investors to the sector.

The Water Supply Licensing (WSL) Regime

The WSL regime already allows a limited form of competition for water supply services in England and Wales. Non-household customers—i.e. businesses, public sector organisations and charities—that use more than 5 megalitres of water per year in England, or 50 megalitres in Wales, are currently able to switch their water supplier to a business licensed under the WSL regime.[2] This business (or “licensee”) can provide either a combination of retail and upstream services or retail services alone. Although eight companies hold water supply licences, only four customers have switched their water supplier on certain sites since retail competition was initially allowed in 2005: C2C, Bernard Matthews, First Milk and Tesco.

[1] This can be through borrowing (debt) or through investment from stakeholders (equity).
[2] This depends on whether the customer is served by an English undertaker or a Welsh undertaker (respectively). Please see the glossary for more information.

The main reason why this regime has not been particularly successful to date is because the prices that licensees must pay to the incumbent water company for using their network are governed by the restrictive “costs principle” in legislation. This has been widely criticised for creating only a small margin on which a licensee can compete when setting prices. As a result, there has not been a great influx of new entrants and incumbent water companies have had little incentive to increase efficiency.

The Water Bill will extend the scope for competition in the WSL regime by removing existing barriers to competition and setting a new framework to ensure that the new markets work efficiently and fairly. Please see the Retail and Upstream briefing notes for more information (including the position of the Welsh Government on implementation of the market reform measures).

The inset regime

The inset regime sits alongside the WSL regime and enables an alternative supplier to replace the water company in a particular geographical area. In contrast with the WSL regime, the inset appointee becomes the monopoly supplier for that area (i.e. a smaller version of the incumbent water company) so that there is no competition after the initial appointment unless a customer is eligible to switch suppliers under the WSL. Some inset appointees provide a bundle of utilities, such as energy and telecommunications as well as water and sewerage services.

The inset regime has been particularly effective at introducing competition in connections for new developments. For example, Albion Water was appointed to provide sewerage services to Knowle village in Hampshire. It set prices below that of the local water company, while simultaneously minimising the carbon footprint and enhancing the site’s biodiversity.

The Water Bill will streamline negotiations between incumbent water companies and inset appointees through the clauses on bulk supply and main connection agreements. Developers are frequently frustrated by the time it can take for an inset appointee to negotiate terms for the necessary connections and water supplies with the incumbent water company. The introduction of codes and charging rules will reduce delay to new developments by decreasing the need for expensive and protracted negotiations.

The self-lay regime

The self-lay regime enables a developer to install the pipework for a new water main or sewer itself, which will be adopted by the incumbent water company afterwards. This can be cheaper and quicker than paying the water company to install the pipes. It can also allow the developer to co-ordinate the infrastructure provision with that for other utilities such as energy and telecommunications.

The Water Bill will provide for Ofwat to introduce codes and charging rules to govern the self-lay regime. This will bring similar benefits to those outlined above as it will also reduce delay to new developments.

Regulation of the water industry

Following privatisation, it has been important to regulate the water industry to protect consumers and the environment. The water industry is regulated by four separate, independent bodies: the Drinking Water Inspectorate, the Environment Agency, Natural Resources Wales and Ofwat.

Drinking Water Inspectorate (DWI)

The DWI is the independent regulator of drinking water in England and Wales, responsible for ensuring that companies provide safe drinking water that is acceptable to consumers and meets the standards set down in law. In England and Wales, in 2012, 99.96% of water met national and European standards.

The Water Bill will enable the Secretary of State to make an order conferring a power on the DWI to set charges for the costs of carrying out its regulatory activities. There are equivalent powers for Welsh Ministers.

The DWI will be a statutory consultee when Ofwat proposes to issue an upstream water supply licence or make a new inset appointment. The DWI must also be consulted when codes are prepared for the reformed WSL and inset regimes.

Environment Agency and Natural Resources Wales

In England, the Environment Agency is responsible for protecting and improving the environment and promoting sustainable development. In Wales, since April 2013, these functions are performed by Natural Resources Wales (NRW). In the water and sewerage sector, both bodies regulate the abstraction of water from the environment as well as the treatment and discharge of wastewater, sewerage and sewage sludge back into the environment. The Environment Agency and NRW also provide guidance to help water companies with their longer term water resource management and drought planning functions.[3]

[3] Each incumbent water company must publish a water resource management plan every five years, which sets out how they plan to maintain water supplies over the next twenty five years. They must also publish a drought plan every three years that sets out how they would intend on managing a drought. The Water Bill will change the frequency of the drought plans from three to five years as well as enabling the Secretary of State (in respect of customers that are supplied by licencees wholly or mainly in England) and Welsh Ministers (in respect of customers that are supplied by licencees wholly or mainly in Wales) to change the frequency.

These bodies will be statutory consultees when Ofwat proposes to issue an upstream water supply and sewerage licence or make a new inset appointment. They may also be consulted when codes are prepared for the reformed WSL and inset regimes.

Ofwat (the Water Services Regulation Authority)

Ofwat is the economic regulator for the water and sewerage sectors in England and Wales. It is responsible for regulating the water industry and ensuring that water companies provide consumers with a good quality service and value for money. This includes setting price limits to ensure that customers receive a fair deal while allowing water companies to raise sufficient revenue for investment; monitoring water companies' performance and taking action to protect consumers' interests (including investigating uncompetitive behaviour); setting efficiency targets for water companies; and making sure that companies deliver the best deal for consumers and the environment in the long term.

The five-yearly **price review** is Ofwat's main mechanism for setting price limits on incumbent water companies.[4] It incentivises efficiency by allowing shareholders to benefit from any performance that exceeds a target rate of improvement.

The next price review process will conclude in December 2014 ('PR14'), covering prices from 2015 to 2020. Ofwat have reformed their approach in PR14, putting customers at the heart of the process and allowing companies greater ownership of their business plans, setting their own outcomes (in line with their customers' priorities) and associated incentives and penalties. In previous price reviews Ofwat signed off all schemes proposed by water companies.

The PR14 methodology includes separate (targeted) retail price caps for household and non-household customers to ensure a greater focus on customers – and also ensure that household customers will not pay more as a result of competition in the non-household market. The approach in PR14 will also incentivise companies away from over-reliance on capital intensive solutions towards those which are most sustainable and cost-efficient.

The Water Bill will improve Ofwat's regulation of the industry by strengthening its powers to ensure that the new markets operate efficiently, fairly and effectively. It will also introduce a new overarching duty for Ofwat to take into account long term resilience when carrying out its duties.[5]

Water Industry Commissioner for Scotland (WICS)

WICS carries out similar functions to Ofwat in Scotland where new entrants can also be licensed to provide water and sewerage retail services. New entrants cannot be licensed

[4] The price cap takes account of factors including the overall rate of inflation, capital investment requirements, and the company's ability to make efficiencies.
[5] NB: This duty will apply to Government too.

to provide upstream services in Scotland. Under the Bill, an application for a licence made to WICS may be treated as if it has also been made to Ofwat (and vice versa).

Consumer Council for Water and Consumer Council for Water Wales (CCWater and CCWater Wales)

CCWater is not a regulator but also plays an important role in the industry by representing water and sewerage consumers in England and Wales. It also handles some customer complaints about incumbent water companies, inset appointees and licensees. CCWater will be a statutory consultee in the preparation of Ofwat's charging rules.

This document/publication is also available on our website at:

https://www.gov.uk/government/policies/reforming-the-water-industry-to-increase-competition-and-protect-the-environment/supporting-pages/reform-of-the-water-market-the-new-water-bill

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PB 14058