

Water Bill

Reform of the water industry: Upstream competition

November 2013

This is one of a series of briefing notes on the Water Bill. This note explains how the Water Bill will enable more competition in providing customers with new sources of water or alternative methods for treating and disposing of their wastewater and sewage – known as upstream competition. Further detail on the Water Bill can be found in other briefing notes.

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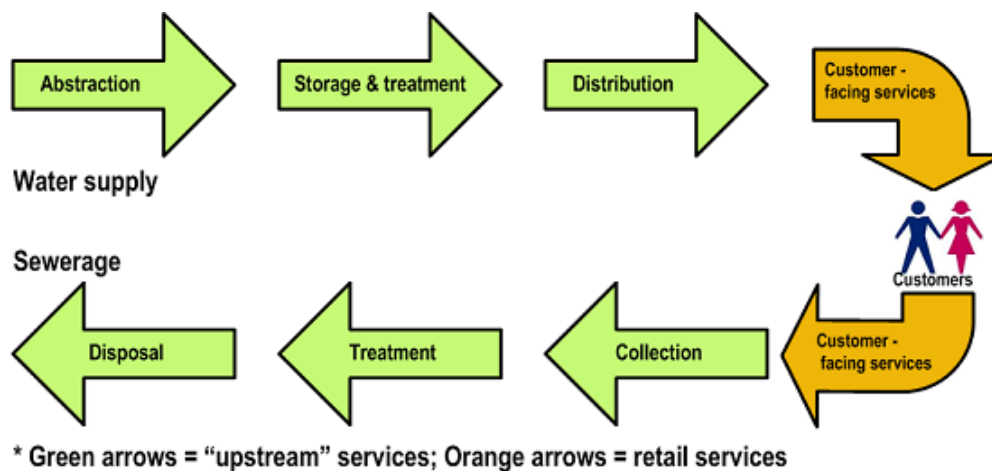
We are facing increasing pressure on our water supplies as a result of growing population and a changing climate. We need to find new approaches to water management which will keep bills affordable by encouraging greater innovation and efficiencies. One way we can do this is by making it much easier for new businesses to enter the water supply and sewerage industry to provide certain “upstream services”.

What are upstream services?

Water companies typically provide their customers with a water supply and remove their wastewater and sewage. This requires sustainable water resources and water treatment facilities as well as sewerage treatment and disposal facilities. It also requires a network to transport the water and wastewater. All these activities are known as *upstream services*. However, only certain upstream services will be open to competition under the Water Bill.

Upstream services are separate from the *retail service* that a water company also provides their customers. This includes sending bills to customers and other associated activities such as reading meters and answering phone calls about water bills or the water supply.

Figure 1: The difference between retail and “upstream” services*



What is upstream competition?

Upstream competition concerns the market for the sale of treated or untreated water into the supply system or the disposal of waste from the sewerage system. The Water Bill will encourage more upstream competition, by making it easier for new businesses and other incumbent water companies to provide certain upstream services. For example, they could develop a new water source and sell it to an existing water company. Alternatively, they could develop a more environmentally-friendly way of treating wastewater, re-using it for industrial use or disposing of sewage sludge. Upstream competition will also make it easier for water companies to buy and sell water from each other, to encourage better

interconnections in the water supply system. Annex 1 provides some possible scenarios for upstream competition.

The original “incumbent” water companies will still be responsible for the vast majority of upstream services. They will still own and manage the network pipes that transport the water, wastewater and sewage. The self-lay regime will remain, but it will be clarified. This regime enables a developer to install the pipework for a new water main or sewer itself before being adopted by the incumbent water company afterwards. This means that the incumbent water companies will continue to provide all the distribution services.

Why do we need to make changes?

Privatisation of the industry was successful in attracting investment that improved the network and produced cleaner water supplies. However, we are now facing a growing population and a changing climate which will put increasing pressure on our water supplies.

We need new approaches to ensure that consumers can continue to have affordable and reliable water supplies which do not damage the environment. We can achieve some of this without new legislation¹, but we also need to reform the water industry to encourage it to be as efficient and innovative as possible.

How will upstream competition help?

Upstream competition will strengthen the resilience of our water supply, while keeping bills affordable. We want to encourage new businesses to bring in new ways of thinking and new approaches, such as alternative water resources and sewerage services. This will help to stimulate the market and to incentivise incumbent water companies to look for the most efficient ways to meet future demand. We also want to increase resilience by encouraging water companies to trade with each other so that water can be moved more flexibly and efficiently to water-scarce areas.

Upstream activities represent roughly 90% of the cost of providing sewerage and water services, so innovation and efficiency in these activities will help us maintain affordable bills for all customers. Our upstream competition impact assessment identified around £1.75 billion of benefits over 30 years as a result of the Bill’s upstream reforms.

There are clear benefits for the environment as well. Local wildlife and ecosystems suffer when there is insufficient water. We can reduce these risks if our reforms encourage, for

¹ We are also taking action to tackle affordability for customers, water efficiency, leakage, pollution and unsustainable abstraction.

example, development of new water storage or water recycling that might reduce the pressure on abstractions from rivers and groundwater. We cannot predict exactly what opportunities upstream competition might bring, but at the very least it would stimulate markets for new water resources, more water recycling and more sustainable treatment and disposal services for wastewater and sewage sludge.

How will the Bill increase upstream competition?

Upstream competition is presently very limited because the current law does not encourage effective competition. For example, the system governing the prices that licensees must pay incumbent water companies for using their network (the “costs principle”) has been widely criticised because – due to the method of calculating costs – it is hard for licensees to earn a big enough margin to be able to compete with incumbent water companies. This lack of competition means there is little incentive for incumbent water companies to become more efficient. Competition is also limited to water supply services only rather than sewerage services and only provides choice to a small number of non-household customers.

The Water Bill removes these barriers to the market and replaces them with a more flexible framework to ensure that the new markets work efficiently and fairly. This will make it easier for licensees to earn a fair return if they have the most efficient service or product as well as increasing opportunities to input water or withdraw wastewater on behalf of customers. It will also give licensees much needed transparency and certainty about the costs they will face. Please see Annex 2 for more detail on the specific changes the Water Bill makes to achieve this.

When will this happen?

We are concentrating first on the retail reforms in the Bill, which will be introduced in 2017. The upstream reforms will be implemented at a measured pace, beyond the 2019 price review. All abstractions of water from the environment will be subject to regulation by the Environment Agency in England and Natural Resources Wales in Wales. The implementation of our upstream reforms will need to be carefully co-ordinated with our planned reforms to the abstraction regime in England. We are already working closely with the water industry, regulators and stakeholders to prepare for the introduction of these new markets while ensuring that the sector continues to be stable, resilient and attractive to investors.

Welsh Government position

The Welsh Government has taken the decision not to implement upstream competition for incumbent water companies operating wholly or mainly in Wales. The Welsh Government does not believe that there is sufficient evidence available at this time to demonstrate whether this will deliver any benefits for Wales and what impacts this will have on their own wider policy commitments relating to infrastructure and the sustainable management of water as a natural resource across Wales.

The Welsh Government has taken a power in the Water Bill to implement upstream competition in the future if evidence suggests that it will provide benefits for the environment, the economy and citizens in Wales.

The Welsh Government intends to monitor the situation in England whilst at the same time considering in the context of wider Welsh Government policy what role an upstream market may have in the future.

Frequently asked questions

How will you ensure that drinking water will remain safe if someone other than a water company is putting water into the public water supply?

The existing regime already allows licensees to input water into the public supply system so there are currently mechanisms in place to protect public health. Water companies will continue to remain responsible for maintaining the supply network and for ensuring that customers receive wholesome drinking water. However, given that the Water Bill will encourage even more competition, we have strengthened the role of the Drinking Water Inspectorate (DWI) so that they will be more involved in licensing and in the development of codes setting out the roles and responsibilities of market participants.

Will increased competition scare away investment in water companies and lead to higher bills for customers?

Investment in water companies helps keep customers' bills affordable and stable. Without private investment, water bills would be around a third higher and significantly more variable from year to year. That is why the Government is committed to ensuring that the industry remains an attractive investment while delivering the changes needed to increase the resilience of our water supplies.

The rate of return that investors receive on their existing investments – i.e. before the Water Bill – will continue to be protected to ensure that water companies can continue to attract investment. Competition should ensure that new investments are made on the most efficient basis, for example where there is clear demand for new water, so that investors' money goes to the right assets. The long lead-in period for upstream competition also ensures that the changes are well-signposted, and that they are developed jointly with the water industry, customers and the regulators.

Why doesn't the Water Bill contain more information about how the markets will work?

We know from experience that setting out in detail how markets should work in primary legislation is very inflexible and stifles innovation – and we need flexibility to learn as we implement and fine tune our approach. That is why the framework in the Water Bill sets the scope and direction of reform, but is not overly prescriptive. Within this framework, the Government will provide guidance to Ofwat on how they should regulate the market, including their approach to charging. The Bill also includes a number of safeguards to ensure that the markets develop and are regulated in a way that is consistent with clear Government policy.

Annex 1: Possible scenarios for upstream competition

Upstream competition could facilitate a variety of scenarios. The new codes and charging rules introduced by the Bill will govern all of these arrangements to make them more efficient and fairer. For example:

- A large brewery with its own borehole wants to supply water to its own public houses and those of its tenants that are located in the same water company area. All the brewery's water supply needs are met by the borehole but it has spare capacity that would meet the needs of those pubs in that area at a cheaper cost than the supply from the water company. Subject to correct abstraction permits, the brewery could make an arrangement to input that water into the water company's supply system or work with a retail licensee that already provides retail services to the pubs.
- A farmer has an on-site reservoir that more than meets the farm's water supply needs. Subject to correct abstraction permits, the farmer could make an arrangement with a licensee for them to input that water into the public water supply system in order to provide water to the licensee's customers. Alternatively, the farmer could make an agreement with the incumbent water company to enable it to put water into the supply system that would be supplied to the wider customer base either on a regular basis or during times of high demand or periods of drought only.
- The incumbent water company in one area has a surplus of water while the incumbent water company in another area does not have enough water. The two parties make an arrangement for a bulk supply of water through a specially constructed pipe connecting the two areas. As a result of this bulk supply agreement, the incumbent water company purchasing the bulk supply is able to stop taking water from an over-abstracted area.
- A large industrial customer with large surface water bills decides to invest in rain water harvesting collection and treatment – including building a treatment works – as well as sustainable drainage systems (SuDs) to reduce its bills. It has built in additional capacity in its treatment works so that it can obtain a wholesale sewerage licence and make arrangements with a retail licensee to treat and dispose of surface water from the premises of the retail licensee's customers that are connected to the same surface water network. This allows it to replace all its water needs for the industrial processes that it would normally purchase from the public water supply network, as well as providing an additional income stream.
- A factory has an underutilised wastewater treatment works on its premises. Previously, the factory owner tried to make arrangements with neighbouring factories to take their wastewater and use up his spare capacity, but these negotiations failed because they were unable to get permission to use the

incumbent water company's network to connect the premises to the treatment works. Subject to the necessary environmental permits, the factory owner could obtain a sewerage licence with a wholesale authorisation and ask the incumbent water company to connect the treatment works to the public sewerage network and make arrangements with a retail licensee to treat and dispose of wastewater from the public sewerage system. The factory owner is therefore able to provide wastewater services to a larger number of customers than he would have been able to by connecting his treatment works to his neighbour's.

Annex 2: What specifically will the Water Bill do to encourage more upstream competition?

The Water Bill will:

- Put in place a new framework for how the market will work and the respective roles of the Government, the regulators and market participants. For further details, please see the fact sheet “How will competition in the water sector be regulated?”
- Extend the main competition regime from water supply only to include sewerage services as well. This allows licensees to treat, recycle and/or dispose of wastewater from the incumbent water company’s sewerage system on behalf of its own customers and those of other licensees.
- Allow licensees to specialise in one particular aspect of upstream services. Under the current regime, licensees also have to provide a retail service to their customers if they wish to provide upstream services. The changes in the Water Bill will enable licensees to concentrate on providing water resources, treatment and/or disposal services while leaving billing, meter reading and other customer-facing services to others with the know-how and resources to provide such services. The Bill will also extend the definition of an incumbent water companies’ “supply system” from referring only to mains and pipes so that it includes reservoirs, treatment works and other storage facilities too. This will increase the opportunities for licensees to input water into the network.
- Make it easier for the owners of water storage, such as farmers, to sell water to incumbent water companies and inset appointees. This will help to increase the resilience of the public water supply and the environment more generally because water can be stored at times when it is less scarce for use in times of scarcity. This may also help farmers to handle extremes of weather better by incentivising improved water storage.
- Make it easier for incumbent water companies and inset appointees to trade water (“bulk supply”) with each other by introducing codes and charging rules. This will help to increase the resilience of the public water supply by enabling water companies to use water resources more flexibly and efficiently. It will also reduce delay to new developments by decreasing the need for expensive and protracted negotiations between insets and the local incumbents.
- Make it easier for incumbent water companies and inset appointees to trade waste water (“main connections”) with each other by introducing codes and charging rules. This may stimulate the development of a market for treated and untreated wastewater. It will also reduce delay to new developments by decreasing the

likelihood for expensive and protracted negotiations between insets and the local incumbents.

- Clarify the regime for a developer to install the pipework for a new water main or sewer itself (“self-lay”) by introducing codes and charging rules. The pipework is later adopted by the incumbent water company afterwards. This can be cheaper and quicker than paying the water company to install the pipes. It will also reduce delay to new developments and it can allow the developer to co-ordinate the infrastructure provision with that for other utilities such as energy and telecommunications.
- Make it more attractive for businesses to enter the market by changing the system for charges that incumbent water companies can put on licensees for accessing the network, for example to input new water or to take out wastewater and sewage for treatment. The current legislation – known as the “costs principle” – has been widely criticised as not encouraging sufficient competition and providing little incentive to incumbent water companies to become more efficient. The Water Bill replaces it with a transparent access pricing regime which will require incumbent water companies to use charges based on charging rules produced by Ofwat.²
- Introduce a “self-supply” licence for suitably-qualified customers. They will be able to supply their own premises either by using their own water resources or disposal services or by purchasing water and sewerage services in wholesale markets.

² The Secretary of State will be under a duty to produce guidance on setting charges to which Ofwat will have regard when producing its rules.

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