Department for Environment, Food and Rural Affairs

Review of Processes for Modifying the Appointment Conditions of Water and Sewerage Undertakers

For discussion

8 November 2013

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1. Introduction

1.1 This discussion paper seeks views from industry and other interested parties about the processes for making and appealing changes to the licences of appointment of water and sewerage companies. The closing date for comments on this discussion paper is 30 January 2014. Please send comments to LicenceModificationconsultation@defra.gsi.gov.uk.

1.2 During 2012, discussions between water and sewerage companies and Ofwat, the water industry regulator, regarding proposals by the regulator to make modifications to the appointment conditions of all undertakers focused attention on the statutory process for making such changes. Earlier this year, the Government announced that it would conduct a review of the licence modification process to explore whether there is any case for amending it and, if so, how this might best be done. The objective of the review is to explore whether there is potential to improve the speed and predictability of outcomes for all parties whilst retaining safeguards.

1.3 The Government has no 'preferred' outcome from this process. All options are on the table, including maintenance of the status quo. The review will be conducted in an inclusive and transparent manner, designed to provide all relevant stakeholders with an opportunity to put forward their views and collaborate in the process. The review will take account of how licence modification processes work in other regulated sectors, but will consider this within the particular context of the water sector. This review process will have no impact on the decisions taken last year on licence modifications to enable the 2014 Price Review. If changes to the licence modification process were to be agreed we would not seek to make them until after new price limits come into place on 1 April 2015.

1.4 This review sits within the context of a wider cross-government review of regulatory and competition appeals. A consultation paper: Streamlining regulatory and competition appeals: consultation on options for reform was published on 19 June 2013.[1] Paragraph 4.96 refers to the cross-government review process and notes that any proposals to reform the process for appealing changes to water and sewerage company licences will be made in the light of the outcome from this water sector specific discussion.

2. Principles

2.1 The overarching principles governing this review are:

- Customers must continue to be effectively protected;
- The Government is committed to maintaining a stable regulatory environment;
- Systems must be capable of evolution to respond to a changing environment;
- Efficient, fair, transparent and predictable systems of modification and redress are essential;
- The Government's *Principles of Economic Regulation*.

[1] www.gov.uk/government/consultations/regulatory-and-competition-appeals-options-for-reform

3. Current mechanism for modifying the appointment conditions of water and sewerage undertakers

3.1 Section 13(1) of the Water industry Act 1991 enables Ofwat to modify the conditions of a company's licence of appointment with the company's consent. Ofwat is required to give notice of proposals to make a modification. This notice must:

- set out the proposed modification(s) and their effect;
- state the reasons why Ofwat proposes to make the modifications; and
- specify a period (not less than 28 days) during which time representations or objections may be made.

3.2 If the company rejects the proposal, section 14 of the Act allows Ofwat to refer the matter to the Competition Commission[2] for a decision on whether the modification should be made and, if so, in what form. The Competition Commission will investigate and report on whether there are matters relating to the functions of water and sewerage undertakers which operate against the public interest; and whether these can be resolved by a licence change.

3.3 The Competition Commission may find that:

- the change proposed by Ofwat should be made;
- a different change should be made; or
- no change should be made.

This decision is final.[3] In determining whether a matter may be expected to operate against the public interest, the Competition Commission is required to have regard to the 'general duties' with respect to the water industry which apply to both the Secretary of State / Welsh Ministers and Ofwat. These are set out in Part 1 of the Water Industry Act 1991.

3.4 Where Ofwat wishes to introduce the same change to all undertakers' licences, they must seek the agreement of each undertaker before the modification can be made to that company's licence. The process therefore requires individual consent from each undertaker, as a result of which industry-wide changes cannot proceed without universal consent.

3.5 It is good process for Ofwat to provide early warning and the opportunity for informal discussion on the content of any potential licence modification. For example, for the recent

[2] The functions of the Competition Commission will be transferred to the Competition and Markets Authority in April 2014.
[3] Although, as with all other such decisions, it is subject to a further challenge by way of judicial review.

proposed modifications to Condition N, a draft of the proposed modification was shared with each of the companies informally. Water UK and the companies discussed the proposed modifications and adopted a constructive approach to drawing points to Ofwat's attention and facilitating understanding that informed the content of the modification that was included in the section 13 notice. This builds on the process that was adopted in late 2012 to secure the agreement of all the companies to licence modifications to support the approach to PR14.

4. Collective Licence Modification

4.1 The draft Flood and Water Management Bill which was published for consultation in April 2009, included provisions for the Secretary of State to introduce standard licence conditions across the water industry and for Ofwat to be able to vary these conditions. It also included a provision for introducing a collective licence modification process, where a change could be made to all undertakers' licences if a simple majority of undertakers agreed to the change.

4.2 In its report on the draft Flood and Water Management Bill, the EFRA Select Committee[4] referred to concerns expressed by a number of water companies regarding the lack of a proposed appeal mechanism. It also highlighted the 80% threshold for agreement, which was at that time used in the energy sector, which a number of companies had identified as being preferable to a simple majority. The Select Committee accepted the rationale for a process to alter standard licence conditions without excessive bureaucracy but pressed for a clear appeal mechanism and greater consultation with the industry. Ultimately, these provisions were not included in the final Bill, due to pressures on Parliamentary time.

4.3 In his *Review of Ofwat and consumer representation in the water sector*[5], David Gray also made a case for modernisation and simplification of the water companies' licences. He recommended that Ofwat and the companies should work together on a process of standardising and simplifying licences and that Government should facilitate the introduction of a mechanism for collective licence modification.

4.4 Ofwat undertook some work in the early part of 2012, with companies, to identify areas of the licence that could be simplified. We understand that Ofwat took the decision to put the licence simplification work on hold, due to the resourcing pressures of the price review. We understand, however, that a draft modernised and simplified licence has been prepared by Ofwat. We understand that Ofwat intends to share this with the companies for comment in 2014.

[4] www.official-documents.gov.uk/document/cm77/7741/7741.pdf
[5] www.gov.uk/government/publications/review-of-ofwat-and-consumer-representation-in-the-water-sector

Water Supply Licensees

4.5 A process of collective licence modification is already in operation for Water Supply Licensees. Section 17I of the 1991 Act sets out the procedure by which Ofwat can modify the conditions of a particular water supply licence with the consent of the licence holder. Ofwat must believe that the change is necessary and will not disadvantage the licence holder in competing with other licensed water suppliers or disadvantage other licensed water suppliers. Subsections (3) and (4) set out the procedure for consulting interested parties about the proposed modification. Before making a modification, Ofwat must give notice:

- stating that it proposes to make the modifications and setting out their effect;
- stating the reasons why it proposes to make the modifications;
- specifying a period (not less than 28 days) during which time representations or objections may be made.

4.6 If Ofwat fails to secure the consent of the licence holder, it must either abandon the modification or refer the matter to the Competition Commission under section 17K. This process is very similar to that currently in place for undertakers.

4.7 Section 17J describes the process for making modifications to the standard conditions of all licences i.e. where Ofwat wishes the modification to apply universally to all Water Supply Licensees. Subsections (3) and (4) require that, before Ofwat makes any modifications under this section, it gives notice identical to that set out above. Subsections (6) and (7) allow Ofwat to proceed with the proposed modifications of the standard conditions if, within the notice period, no objections are made by the relevant licence holders.

4.8 If one or more licence holders do make an objection, Ofwat can still go ahead with the modification in cases where:

- the percentage of the relevant licence holders making objections is below a percentage specified by order; and
- the proportion of relevant licence holders (weighted according to market share) is below a percentage specified by order.[6]

4.9 If one or other of these tests is not met, Ofwat may not proceed with the proposed modification. Ofwat then has three options: it can abandon the proposals, alter them in the hope of gaining sufficient support in a further consultation, or decide to make a licence modification reference to the Competition Commission.

[6] Article 3 of the Water Supply Licence (Modification of Standard Conditions) Order 2005 (SI 2005/2033) specifies the relevant percentages as objections made by 20% or more of relevant licence holders measured by number or by market share. Article 4 of this Order specifies how each relevant licence holder will be weighted for the purposes of measuring market share.

4.10 The procedure for Ofwat to refer proposed modifications of water supply licences to the Competition Commission largely parallels the existing procedure for undertakers. Ofwat can ask the Competition Commission to consider the extent to which the proposed modification addresses matters which operate, or may operate, against the public interest. This includes modifications both to the conditions of particular licences and to the standard conditions. In reaching a decision the Competition Commission must have regard to the general duties under Part 1 of the Water Industry Act.

4.11 The Water Bill, currently before Parliament, includes provisions to introduce the same procedure for changes to sewerage licences which will be issued to new entrants once the Water Supply Licensing regime is extended to cover sewerage services.

5. Secretary of State's Powers of Veto/Direction

5.1 Under the procedure for making modifications to the licences of water and sewerage undertakers the Secretary of State has a limited power of intervention. During the consultation period specified in the notice issued under section 13(2) the Secretary of State may direct Ofwat not to make the proposed modification. However, this power is only available where:

- the regulator wishes to modify licence conditions for the purposes of making a new or varied appointment under the inset regime as provided for in section 7(4)(c)[7];
- the modification relates to the disposal of a company's protected land and the license of appointment states that this particular provision cannot be modified; or
- it appears to the Secretary of State that the modification should be made, if at all, through the powers available to the Competition Commission rather than through the powers available to Ofwat.

5.2 Under the parallel procedure for making modifications to the licences of Water Supply Licensees, the Secretary of State has a much wider power to Direct Ofwat not to make a proposed modification to either an individual company's licence or to the standard conditions of all companies' licences. In this context, once the Secretary of State (or for companies wholly or mainly in Wales Welsh Ministers) has received a copy of the reference to the Competition Commission notifying him of an intended change, he has 28 days during which he may decide whether to direct the Competition Commission not to investigate the reference.

[7] In broad terms, section 7(4)(c) relates to conditions in an undertaker's licence of appointment which govern the circumstances where another company may replace that undertaker as a relevant undertaker in relation to the whole or part of its area.

6. Processes in other regulated sectors

6.1 The mechanisms for modifying the licence conditions of companies in the regulated sectors can be broadly divided into two models: the regulatory reference model and the direct appeal model.

The regulatory reference model

6.2 This is the model which currently operates for modifications to licences made under the Water Industry Act 1991 (both for undertakers and water supply licences) and the Railways Act 1993. This model was also previously adopted in the communications and postal sectors under the Telecommunications Act 1984 and the Postal Services Act 2000 before being replaced by something closer to the direct appeal model. It was also used for the energy sectors under the Gas Act 1986 and Electricity Act 1989 (before the Electricity & Gas (Internal Market) Regulations 2011 came into force).

6.3 Under the regulatory reference model, if an undertaker or licence holder (or a specified proportion of undertakers or licence holders) does not agree with the regulator's proposals to make licence modifications, the regulator can either abandon their proposal or refer the matter to the Competition Commission to be reconsidered. The Competition Commission is then required to determine the merits of the matter in the overall public interest, taking into account the statutory duties of the regulator.

6.4 This process is only triggered where the regulator and the regulated entity cannot come to an agreement regarding the proposed licence change. In some cases, agreement across the affected sector must be universal (the Water Industry Act 1991; Railways Act 1993); in other cases the regime adopts a collective licence modification system. For example, modifications made to the standard conditions of water supply licences under the Water Industry Act 1991; and standard conditions of gas or electricity licences before the Electricity & Gas (Internal Market) Regulations 2011 came into force.

6.5 Usually these procedures confer a power of Direction on the Secretary of State to veto the proposal (or to Direct either the regulator or the Competition Commission not to take forward the proposed change). For example, the limited powers of direction available for modifications made to the conditions of appointment of water and sewerage undertakers; and wider powers available in relation to modifications of water supply licences. Similarly, section 13(5) of the Railways Act 1993 allows the Secretary of State to direct the Competition Commission not to proceed with a reference made by the Office of Rail Regulation or alternatively not to give effect to the proposed variation. Similar powers existed under the Gas Act 1986 and Electricity Act 1989 (before the Electricity & Gas (Internal Market) Regulations 2011 came into force).

6.6 The Competition Commission must usually reconsider the whole matter on its merits, although in practice it is likely to concentrate its inquiries on the particular areas of disagreement which have been identified between a regulator and the licence holder. The

party affected by the modification decision cannot choose the issues and evidence which they want to be re-examined.

6.7 The process adopted by the Competition Commission in these cases is inquisitorial, rather than adversarial, meaning that it conducts an investigation rather than adjudication between parties to a dispute. The Competition Commission, rather than the regulator or affected parties, decides what evidence it needs to gather and assess.

The direct appeal model

6.8 This is the model which currently operates for licence modifications made under the Gas Act 1986 and Electricity Act 1989 (as amended by the Electricity & Gas (Internal Market) Regulations 2011) and the Civil Aviation Act 2012. In these cases the regulator may make a licence modification and the licence holder or another affected party can make an appeal directly to the Competition Commission. The responsibility is with the appellant to identify the element(s) of the regulator's decision that they believe are wrong, and to bring evidence to support their appeal. As an initial step, the appellant will need to apply for permission to bring the appeal, generally in line with the standard required for judicial review.

6.9 The Competition Commission will judge the appeal on the basis of submissions put forward by the regulator and the appellant. The standard of review varies across the regulatory regimes:

- some adopt the same standard as judicial review (i.e. there has been an error in law or a procedural defect);
- some look at the merits of the decision; and
- others set out specific parameters.

For example, under section 26 of the Civil Aviation Act 2012 the grounds of appeal are that the decision is based on an error of fact and/or that it was wrong in law; and/or that an error was made in the exercise of discretion. There is usually no power available to the Secretary of State to prevent the appeal or veto the licence modification.

Consultation on Streamlining Regulatory and Competition Appeals

6.10 The Government has recently sought the views of all interested parties through a consultation on Streamlining Regulatory and Competition Appeals. This consultation responds to concerns that in certain sectors there are a significant number of appeals of regulatory decisions, with relatively little downside risk to a company from lodging an appeal. In the communications sector in particular, the Government is concerned that appeals may sometimes be seen as a chance to re-open regulatory decisions, encouraging lengthy and expensive litigation and holding back decision-making. In other sectors there are far fewer appeals. Overall there is a significant degree of diversity in the

way these issues are handled across sectors in terms of which appeal bodies hear which types of appeal and the standards by which those appeals are decided.

6.11 The purpose of the consultation on streamlining regulatory and competition appeals has been to seek views on whether the appeals frameworks for regulatory and competition decisions strike the right balance between providing a proper right of challenge and allowing regulators and competition authorities to make decisions in a timely way. It set out a range of possible options for reforming appeals regimes.

6.12 These include options for shifting the balance away from the regulatory reference model and towards the direct appeal model and having a presumption in favour of a judicial review standard of appeal as opposed to appeals 'on the merits'. In assessing these options, the Government is conscious of the importance of maintaining and reinforcing regulatory certainty. The Government recognises that some of the existing differences between sectors reflect genuine differences in the nature of the decisions being made. In deciding the way forward and reflecting on the responses to this consultation, the Government will be mindful to preserve the best features of the current regimes.

7. Discussion

7.1 To date Ofwat has never used its power to refer a licence amendment to the Competition Commission. It has been suggested that the current system of making licence changes may incentivise Ofwat to seek as much change as possible each time an amendment is proposed, due to the complexity of the process and associated costs. Equally this has led to Ofwat minimising the number of amendments it seeks. At the same time, the need for the individual consent of each undertaker before any industry-wide changes can take place may limit the incentive for constructive industry-wide debate about changes that may be in the wider public interest.

7.2 In previous discussions on this topic, for example in response to the relevant clauses in the draft Flood and Water Management Bill, some companies have suggested that a collective licence modification procedure mirroring that which was previously used for the energy sectors under the Gas Act 1986 and Electricity Act 1989 (and which is currently in place for the WSL regime) could potentially be acceptable. This approach would allow the regulator to make changes to a standard licence condition in circumstances where 80% of companies (measured by number or by market share) had agreed to a change. In order to move to this model there would need to be greater standardisation of the existing licence conditions. So one area for discussion must be the potential for the water industry to adopt more standard licence conditions by common consent.

7.3 When the Ofwat Review explored this matter in 2011, David Gray noted that:

> *"The companies, in general, are nervous of licence reform, largely because they have concerns about the policies which such reform would be intended to facilitate.*

They are also concerned that any significant changes to the effect of the licences (as opposed to simplification and modernisation) would have implications for financing arrangements which, in general, include covenants restricting their ability to undertake certain actions and allowing repayment or renegotiation of the terms of the loan in the case of any material adverse change."

7.4 However, whilst recognising the validity of concern about the costs that could arise from the need to renegotiate the terms of financing arrangements which appeared reasonable in the context of the licence conditions applying at the time, the review also considered that the case for modernisation and simplification was clear. Gray argued that "it is not reasonable for the companies to resist simplification simply to frustrate Ofwat's ability to introduce changes". A further area for discussion, therefore, is how to balance concerns about the impact of any change to the licence modification process with the need for appropriate levels of consistency and coherence between companies and the role of the regulator in ensuring consumers are protected. An area for further discussion must be around the most effective way of developing and introducing licence modifications that seek to avoid an adversarial approach. Is there scope to build on the mature and positive engagement that has characterised the way in which modifications to Condition N have been handled. Is there value in more regular review of the licence conditions to make sure they remain fit for purpose?

7.5 Through the Open Water programme, the industry is currently engaged in developing the detailed framework to support the implementation of the market reforms set out in the Water Bill. This includes a substantial work stream with the objective of creating a level playing field for all market participants. Areas for further exploration may include the case for greater coherence between the processes for making changes to the licences of undertakers and water supply and sewerage licensees.

7.6 In regimes with a collective licence modification process there is also frequently a Ministerial power of intervention, usually taking the form of a Direction either to the regulator or another competition authority. In effect this represents a Ministerial 'veto' of any proposed change. This power of veto already exists in the context of the WSL regime. It also exists in a very limited fashion under section 13(2) in relation to changes to undertakers' conditions of appointment. One area for discussion will be whether there is a case for extending this power of veto to create greater coherence with the WSL regime.

7.6 The Government has recently concluded a consultation on proposals to move away from the regulatory reference model and towards the direct appeal model in relation to regulatory appeals processes. The consultation also considers introducing a general presumption in favour of a judicial review standard of appeal as opposed to appeals 'on the merits'. The consultation noted the importance of recognising the specific differences between sectors and the differences in the nature of the decisions being made. We would therefore, welcome your views on the implications of these proposals for the water sector in particular, with specific reference to the appeals process in relation to modifications to undertakers conditions of appointment.

Questions

1. Is the current system for licence modifications fit for purpose, and if not, what are the most significant issues that need to be addressed and how would you propose to address them?

2. What are the merits of the current system?

3. Is there greater scope for the industry and the regulator to reach consensus on some standardised licence conditions where appropriate, and if so, how would you propose taking this work forward?

4. Are there benefits to more regular reviews of licence conditions? Are there circumstances in which companies might wish to pursue licence modifications?

5. What are the merits of alternative systems of licence modifications in other industries that could be applied within the water industry?

6. Does a level playing field for all market participants, imply standardised licences? If collective licence modification were to be an acceptable way forward, what would constitute an appropriate ‘majority’ and what is your rationale for this?

7. Would an extension of the existing power of Ministerial veto to create greater coherence with the WSL regime make the prospect of a move towards collective licence modification more or less acceptable to the industry?

8. Is an appeal mechanism required for the licence modification process, and if so, what should be the main features?

9. What are the implications for the industry of proposals to move away from the regulatory reference model and towards the direct appeal model in relation to modifications of undertakers’ conditions of appointment?

10. What are your views on the implications of a judicial review standard of appeal as opposed to appeals ‘on the merits’ in the specific context of appeals of proposed modifications of undertakers’ conditions of appointment?

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