

RESPONSES TO THE CONSULTATION QUESTIONS

Approaches to Access Pricing

1. Do you agree that the current access pricing regime inhibits the development of effective competition? If not, please explain why and how you consider the current regime should be applied (you may wish to refer to our Outcomes Paper).

No. The current access pricing regime limits the scope for profitable entry to firms that can do something more cheaply than the incumbent undertakers, but that is not the same thing as inhibiting the development of effective competition. Lower access prices might increase entry, but that is not necessarily synonymous with “the development of effective competition”. Indeed, it appears that the Government did not think it was when it formulated the WSL regime. Dŵr Cymru believes that, for a case to be made for a less restrictive regime, it is for Ofwat to examine competition from first principles, and to evaluate the costs and benefits of changes to the access pricing regime. If this is not done there is a real risk that changes will be implemented that will increase total costs which would be detrimental to the interests of customers.

In addition, it should be noted that the “service market” competition which is the subject of the consultation is just one example of competition, and other forms can also be effective and make a contribution towards the delivery of better value services to customers. In particular, Dŵr Cymru believes that competitive out-sourcing offer significant potential gains for customers, and has implemented a comprehensive programme of using the market for operating and other services in order to achieve this objective.

2. Do you support the suggestion that the principles governing the access pricing regime should be set out in legislation and that we, as the economic regulator should develop the detail?

This is essentially a question as to whether access pricing policy is of such importance that it should be determined by Government and enshrined in legislation. Dŵr Cymru believes that it is, and therefore that the policy (as well as just broad principles) should be determined by Government, not the regulator. Clearly it is entirely appropriate for the detail to be developed and regulated by Ofwat, but not the policy. Note, also, that the list of principles set out on page 21 of the consultation paper is based on a presumption as to what is the right level and type of competition, but Dŵr Cymru believes that the onus falls on Ofwat to establish that this is the case by reference to first principles and a careful evaluation of the costs and benefits of extending competition. It is not adequate to state “*we believe that it would be appropriate to develop an access pricing regime that better reflects the underlying cost of access and is better designed to aid new entry and the development of effective competition*”. Not only is this an assertion, but it appears to be in conflict with existing Government policy, as enshrined in the present WSL regime.

3. In considering appropriate access regimes:

- do you think there should be different access pricing regimes for different parts of the supply chain? If so why and for what parts?

Dŵr Cymru believes that this question can only be properly addressed once a full analysis has been carried out, based on first principles, of what type and degree of competition is appropriate. Until conclusions have been reached as to what markets should be liberalised and what it is hoped to achieve by doing so, the “right” access pricing regime cannot be deduced. It is possible, once this is done, that there might be different regimes for different parts of the supply chain but it seems unlikely. Certainly, at present, under the WSL arrangements and the policy on which it is based, there is no case for different regimes.

- What are your views on the lessons that could be drawn from the approach to access pricing adopted for retail-only water competition in Scotland and for common carriage in New South Wales, Australia, or from the approaches that are used for access pricing in other utility sectors in the UK?

Neither the Scottish nor the New South Wales regimes have been in place for any length of time, so no strong lessons can be drawn as yet as to outcomes. Clearly, though, both examples will offer useful potential lessons in the future. Consequently, they should be observed closely by Ofwat and others over the coming years: clearly, though, it would be premature to make any changes in England and Wales on the basis of those approaches until those lessons are clear.

It is worth noting, however, that the architects of the arrangements in Scotland have acknowledged, and addressed, some of the issues that have been the subject of controversy in the way in which the WSL regime has been implemented. For example, there has been a vigorous debate regarding undertakers’ exposure to licensees that have poor credit ratings by comparisons with the ultimate customers that are being served. In the Scottish arrangements this problem has been legislated away by requiring that retailers pay their wholesale charges in advance.

As regards access pricing in other sectors, we do not believe that there are direct lessons that can be drawn for the purposes of informing the question of access pricing in the water sector, because of the lack of direct comparability. For example, in gas and electricity the firms that charge for access do not themselves provide services to final customers, so questions regarding the interaction between the two functions do not arise, nor do issues regarding the co-existence of “essential natural monopoly services” with competitive activities within the same firm. Whilst the general experience of the liberalisation of markets in other sectors provides useful and informative background, the “right answer” for access pricing in the water sector must be derived from a careful analysis of what form and degree of competition offers the prospect of the greatest net benefits for customers, and what that implies for the level and structure of access pricing.

4. What access pricing methodology would you recommend and why? What do you see as the key advantages and disadvantages of each of the alternatives?

As set out above, this all depends on the prior analysis that determines what is the right policy for the development of competition having regards to the costs and the likely benefits. It would be wrong to attempt to address this question without having done so, because of the real risk that customers would ultimately end up paying more as a result.

5. What implications would each access pricing methodology have for cost reporting? Would any of the approaches require other changes either to the WSL regime or to how Ofwat regulates appointed water companies?

The implications of different methodologies for cost reporting would depend on the exact nature of the methodology employed. As to other changes that would be required, the discussion in the consultation paper is too general for specific changes to be identified, because it all depends on what is the right answer in terms of the development of competition, and the strategy for implementation. For example, if approaches to access pricing are employed which lead to substantial reductions in undertakers' business, various consequential questions arise (e.g. what would be the effects on the cost of capital). In particular, the Government clearly recognised the problems inherent in a structure where, because of the way Ofwat has to regulate the sector, "captive" customers would essentially be under-writing undertakers' losses in the competitive market. This is clearly unacceptable, unless there is a confident expectation that competition will eventually be rolled out to those customers as well, and that this will, on balance, be a "good thing". What this demonstrates is that the question of access pricing cannot be viewed in isolation from the whole of the economic regulation regime, and needs to be addressed in as wide a context as possible.

The Eligibility Threshold

6. Do you support Ofwat's view that the threshold should be reduced? If not, please explain why.

Dŵr Cymru does not have a strong view on the threshold, but it does not agree with Ofwat that it is a major issue. If entrants are not sufficiently attracted by large industrial customers with seven-figure annual water bills, it is difficult to see why the introduction of small customers into the market will make much difference. The inset threshold was lowered around 1999 for similar reasons from 250 Ml to 100 Ml, but that had a similarly negligible effect. (Note, however, that it would be unfortunate if Ofwat brought about a reduction in the threshold in a manner that generated expectations that the market was suddenly going to "take off".)

7. To what level (if any) should the threshold be reduced and why?

See the answer to question 6 above. Dŵr Cymru does not have a strong view.

8. If you support a reduction in the threshold, should it be a single or stepped change? Why?

Dŵr Cymru does not have a strong view.

9. Over what timescale do you think the threshold should be reduced? Why?

Dŵr Cymru does not have a strong view.

10. What changes do you think would be needed elsewhere in the WSL regime to make competition work with a lower threshold?

The question pre-supposes that “competition isn’t working”. We do not think this can be assumed. As set out above, Government legislated to create a very specific regime for competition in the water industry. Implicit in the design of the WSL regime is the policy that entry should only occur where a licensee can do something more cheaply than an undertaker, and profit as a result. The lack of entry may simply reflect the scarcity of such opportunities, whether because inefficiency amongst undertakers is limited, or because there are physically few potential water sources for entrants to exploit. Alternatively, there may be significant non-price barriers to entry of some kind: if so, it is for Ofwat to investigate what they might be and work to address them.

Definition of Premises

11. Do you agree with Ofwat’s proposal not to change the current guidance on the extent of premises? Please give reasons for your response.

Dŵr Cymru does not have a strong view on the extent of premises.

Contractual Aggregation

12. Do you agree with Ofwat’s proposal not to consider multi-site aggregation at this time? Please give reasons for your response.

Dŵr Cymru does not have a strong view on the question of multi-site aggregation.

13. Do you believe that in-area trading should be allowed? If not, please explain why and propose an alternative approach.

Dŵr Cymru does not have a strong view on in-area trading. However, it observes that the additional regulation that would be required if in-area trading were permitted would further add to the administrative and transactions costs of a regime which is already costing companies and the regulator (and therefore ultimately customers) a not insignificant amount of money.

14. If you consider that in-area trading should be allowed, what regulatory controls do you think would be necessary to safeguard the development of competition and protect consumers?

See the answer to question 13 above. A set of fairly intrusive and comprehensive measures would be required in order to ensure a level playing field between associated companies and other licensees.

Licence Application Fees

15. Do you agree with the removal of specific licence application fees and the recovery of the relevant costs via the normal mechanism instead? If not please explain why and propose an alternative approach.

In financial terms Dŵr Cymru does not see this as a major issue. However, as a matter of *principle*, the Government was clear that the generality of customers should not have to contribute towards the costs of the WSL regime, so it does not appear that it really falls to Ofwat to decide otherwise. The problem, as ever with such issues, is that it is very tempting to take the approach that when looked at on a per household basis the amounts in question will be negligible, but this does not provide a reason for abandoning the principle set by Government. If Ofwat were very anxious to relieve entrants of the application costs, the logical solution would be to have the costs recovered as a levy on the 2,200 eligible customers, by means of undertakers' and licensees' tariffs. Indeed, the same approach could be used in respect of all of Ofwat's WSL costs, which are believed to constitute a material proportion of the regulator's budget. This would also have what many would see as the benefit of raising awareness amongst customers of the WSL regime, although Dŵr Cymru would caution against fuelling further unwarranted expectation as to what the regime might deliver.

Supplier of Last Resort

16. Do you agree that the current regime effectively provides the equivalent assurances as a SoLR regime, and that as a result changes are not needed to the present SoLR regime? Please give reasons for your response.

As Ofwat has argued, the current regime does possess some SoLR features, although there are never any 100% guarantees of supply. It should also be borne in mind that there is a significant self-supply sector amongst industrial customers in England and Wales, especially for non-potable water, and they bear their "buyer beware" responsibilities without apparent difficulty, so this should not be a major issue for customers of licensees. Accordingly, we do not see any case for changes.

17. Do you agree with the proposal that water undertakers make their SoLR duties and obligations public, including the terms and conditions they would offer returning customers? Please give reasons for your response.

The SoLR duties and obligations are “public” in any event, but it should not really be for undertakers to promote awareness of them to customers. This, if anything, is a role for customer representatives and Ofwat. As to terms and conditions, it would be wrong of an undertaker to state categorically what terms and conditions it would offer returning customers because that is a matter that would depend on the circumstances at the time. Indeed, if an undertaker did so, and were subsequently bound to those terms and conditions at the time the customer returned, that could be in conflict with what the undertaker’s statutory duties required at the time, for example by elevating the priority accorded to non-domestic supplies higher than what is provided for by the Act.

18. Do you agree that improved communication and publication of additional information about customers’ rights will ease current concerns?

Dŵr Cymru does not know whether such concerns would be allayed by the availability of more information.

Competition in the Provision of Sewerage Services

19. Do you consider that retail competition in sewerage should be included as part of the WSL regime? Please give reasons for your response.

No. As set out in our position paper we think that “retail competition” of the type (uniquely) established for the water sector is unlikely to give rise to material benefits, and entails not insignificant costs. (Note: Dŵr Cymru observes that “retail competition” for sewerage services has been introduced in Scotland. However, this has been achieved by the creation of a margin between the (default) retail charges and the wholesale charges that have been fixed by the regulator. This is likely to secure entry, but it is not yet clear that customers, as a whole, will be better off, especially as, on the regulator’s own figures, some £10m of additional transactions/duplication costs will be incurred as a result of the new regime.)

20. Do you think combined competition for the provision of sewerage services is possible and/or desirable? Please give reasons for your response.

Competition by means of vertical separation of functions and common carriage is not generally feasible in sewerage. The principle of common carriage relies upon there being reasonable homogeneity in the services being offered and, more particularly, the product being transported. It does not matter if the gas a customer receives is not, physically, the same gas which its supplier put in at the production end and there are no (or negligible) cost consequences arising as a result. This is not, however, the same for wastewater, the characteristics of which vary significantly between customers, especially between domestic customers and trade effluent customers. The cost consequences of having to treat different types of effluent are generally quite significant, and indeed a number of the parameters of trade effluent which drive cost differences are measured and charged for at present. In short, it is not possible for a sewage treatment “producer” to take out what its customers put in. Therefore, in the absence of inevitably complex (and, ultimately, self-defeating) arrangements for balancing payments to compensate for differential effluent loads, common carriage in sewerage, as a general proposition, is not practically feasible.

Inset Appointments

21. Do you think that the options set out above for changes to the inset guidance are sufficient?

Yes. They are comprehensive.

22. Prior to the issue of the inset appointment guidance consultation are there any other issues that Ofwat should cover in its guidance?

No.

Accounting Separation

23. Do you agree that accounting separation could bring benefits in terms of transparency and could facilitate more effective competition? Please explain your answer.

Not necessarily. Accounting separation is a necessary measure to support competition of certain types. It is not a “driver” or “facilitator”. First, Ofwat must decide what is the right type and degree of competition for the sector, as described earlier, by applying first principles and following a careful evaluation of costs and benefits. Whether accounting separation is required or not would “fall out of” the results of that analysis.

24. What functions or activities do you consider should be accounted for separately and why?

See the answer to question 23 above. It is not possible meaningfully to say what activities should be accounted for separately until the overall “vision” for effective competition has been established.

Structural Separation

25. What do you consider would be the benefits and detriments of considering structural separation in water and sewerage services? Please give reasons to support your response.

As for accounting separation, structural separation is a consequence of the answer to the question: “what is the right model for competition in the sector?”, not a “facilitator” or “driver”. Certainly, if full market liberalisation were thought to be the “right answer”, then structural separation would be preferable to support that model, since experience from other sectors shows that a “clean break” tends to work better than accounting separation.

Household Competition

26. Do you consider that there are potential benefits to be gained from household competition?

There are “potential benefits”, but on a first view these appear to be very limited, and may be more than likely outweighed by the costs. It is for Ofwat, however, to carry out a detailed analysis of the balance between the two. Dŵr Cymru’s position paper on competition sets out a framework for carrying out this work, together with some of the important considerations that would have to be addressed.

27. Should household competition be considered in parallel with greater metering?

No. The competition question is the prior one, and any consequences for metering should follow.

Competition in the Production of Water

28. Do you agree with our assessment of the opportunities for competition in this area?

On the face of it, competition by means of the creation of water markets in the environment appears to offer much greater scope. The options described by Ofwat are of a “piecemeal” or “incremental” nature: what is required is a more fundamental review. In particular, Dŵr Cymru is not convinced that the 400 or so separate “markets” for water abstraction and treatment that currently exist in England and Wales are potentially large enough and competitive enough to generate significant benefits. Ofwat should evaluate a possible “inter-connection strategy”, as in gas markets, to see whether or not market aggregation would be worthwhile. More promisingly, however, Dŵr Cymru believes that the liberalisation of markets for water rights in the environment theoretically offers far greater scope for benefits and, albeit that this would entail radical reforms, this is where Ofwat’s attention should focus.

29. Do you consider there are any other factors that we need to take account of?

See the answer to question 28 above.

30. Do you have any other suggestions for developing competition in this area?

See the answer to question 28 above.

Competition in Abstraction

31. Do you agree with our assessment of the water rights trading regime? Please give reasons for your response.

No. Although trading is technically permitted, the regime is still largely administrative and characterised by too much regulatory risk. For water rights trading to make a major contribution to competition (and to wider environmental objectives) a more fundamental set of reforms would be required.

32. Please consider how we can increase awareness of the abstraction trading regime?

Licence-holders are the individuals and organisations that have the incentive to make trading happen, because they are the ones that can benefit. Therefore, the Agency and Ofwat should concentrate on making them aware of the possibilities available to them.

33. Please consider how we could further facilitate water rights trading? Do you agree with our proposals for changing this? What other suggestions would you make?

See the answer to question 31 above. Dŵr Cymru believes that Ofwat should investigate what a proper regime for tradeable water rights would involve, and to evaluate the costs and benefits.

34. Are there any other strategies that Ofwat could pursue to assist with the facilitation of combined supplies under the WSL regime?

The Agency could be asked to provide an assessment of where spare water might be available to licensees.

35. What other steps could Ofwat take to increase competition in abstraction?

See the answers to questions 31-33.