

THE LEGALITIES OF COMPETITION IN WATER MARKETS – COMPARING SCOTLAND WITH ENGLAND AND WALES

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On 1 April 2008 the market for non-household water and sewerage services in Scotland ‘went live’. For the first time, business customers were able to choose their water and sewerage retailer in much the same way as they are accustomed to doing for other utility services, such as telecommunications, electricity and gas. During the three years leading up to that market opening the Scottish industry regulator, the Water Industry Commission for Scotland (WICS) was working to implement the Water Services etc (Scotland) Act 2005 (2005 Act), which formed the basis for the newly competitive market. This article provides an explanation of the main legal elements of the market systems and rules that it devised. At time of writing, the industry regulator in England and Wales, the Water Services Regulation Authority (Ofwat) and the Department for Environment and Rural Affairs (Defra) are conducting their own inquiries into the development of competition in the water industry throughout the rest of Great Britain, and this article therefore also provides some observations on the comparison between the main legal elements of the Scottish market’s systems and rules and the respective provisions south of the border.

THE STATUTORY AND LICENSING CONTEXT

Prior to the introduction of non-household competition, Scotland had only one incumbent monopoly provider of water and sewerage services, Scottish Water. Unlike the English and Welsh companies, Scottish Water is a statutory, publicly owned company and does not operate under appointment or licence. Instead the scope of its authority is defined by a series of Scottish Acts, including the Water (Scotland) Act 1980, the Sewerage (Scotland) Act 1968 and the Water Environment and Water Services (Scotland) Act 2003. Section 11 of the 2005 Act also gives WICS a relatively broad power of direction that can be used to compel Scottish Water to take steps in support of the participation of new entrant retailers in the competitive water and sewerage markets. WICS has used this power on a few occasions, notably in relation to the development of wholesale terms and conditions as further described below.

While the 2005 Act preserves Scottish Water’s monopoly of the wholesale and infrastructure elements of the water and sewerage supply chain, section 7 of that

Act authorises WICS to grant retail licences for the provision of either (or both) water or sewerage services. These licences allow a retailer to contract with Scottish Water for the wholesale provision of water and/or sewerage services and then retail those services on to non-household customers. Engaging in the provision of water or sewerage services without that authorisation is a criminal offence.

WICS has developed a set of standard conditions that apply in all retail licences. These conditions oblige the retailers to comply with the various industry codes and agreements that have been developed (and are described below) and provide a legal basis on which WICS can recover information it needs to perform its various statutory functions. WICS has also developed specific sub-sets of standard conditions that would apply were a retailer licensed solely to provide water and sewerage services to itself (a ‘self-supply’ licence) or very particular services to a very particular class of customer (a ‘specialist’ licence). If a retailer breaches any of the conditions of its licence then it would be for WICS to investigate the matter and seek to enforce the condition. Ultimately, it could revoke the licence, so forcing the retailer to cease providing water or sewerage services, lose its customers and leave the market.

The competition regime in England and Wales is governed by the Water Industry Act 1991 (WIA91). That Act is the basis on which Ofwat appoints both the undertakers (ie the incumbent monopoly providers of water and sewerage services such as Thames, Yorkshire and Welsh Water) and licenses new entrant water suppliers. Such licensing allows Ofwat a degree of secondary control, additional to the broad provision made under statute, over the behaviour of the water and sewerage undertakers and suppliers.

There are broadly three different types of ‘new entrant’ activity that can be authorised in England and Wales.

1) Retail activity. The grant of what is known as a ‘retail licence’ under section 17A of the WIA91 will allow the licence holder to purchase a wholesale supply of water from the incumbent water company to whose network its customer is connected and supply that water to its customer. In this regard it is the most comparable option to the scope of the Scottish licences.

2) Combined activity. The grant of what is known as a ‘combined licence’ is also made under section 17A, but includes the ‘supplemental authorisation’ referred to in subsection 5 of that section. This type of licence authorisation will allow a supplier to purchase water

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from one water undertaker and supply it to its customers via another undertaker's infrastructure.

Both retail and combined licences only authorise water supply to non-household customers who are not likely to use less than 50 megalitres of water in any year. Supply licences are not available in respect of sewerage activity in England and Wales.

3) Inset appointments. These appointments are made by Ofwat under section 6 of the WIA91, (which is also the basis for formal appointment of the incumbent regional monopoly undertakers). Inset appointments allow new entrants to take over a defined geographic area of the water or sewerage infrastructure from an incumbent water/sewerage undertaker. Broadly speaking, unless the incumbent water/sewerage undertaker consents to an inset appointment being made within its area, water inset appointments are also only available to serve specific customers who are likely to consume at least 50 megalitres of water in any year (250 megalitres in Wales).

Unlike the arrangement in England and Wales, common carriage (or the transportation of water or sewage by one party via the infrastructure of another), is prohibited in Scotland. Retail licence authorisation will, therefore, only permit a retailer to 'make arrangements' for the provision of water or sewerage services. There is no consumption threshold for the contestability of water or sewerage services in Scotland, the only requirement being that the customer is an 'eligible' one. At a statutory level, eligibility is dependant on occupation of 'eligible premises', defined in section 27 as being premises that are both connected to the public system and not a 'dwelling' for the purposes of Council Tax legislation. Consequently, a retail licence in Scotland authorises the licensee to contract with any non-household occupier of any premises that are connected to the public water or sewerage system.

The structure created by the statutory and licensing regime in Scotland is similar, if not identical, to that which exists in England and Wales. Most notably, competition in Scotland has been restricted to the customer facing retail end of the supply chain only. However, there is no consumption threshold within that retail market and both water and sewerage services may be supplied.

WHOLESALE TERMS AND CHARGES

Both the 2005 Act and the WIA91 envisage that there should be a contract between the licensee and Scottish Water or the relevant English/Welsh incumbent setting out the terms on which the licensee will be supplied with water or sewerage services. However each jurisdiction has taken a different approach to the agreement of these terms and conditions, including in relation to the charges levied under the agreements.

In Scotland, because Scottish Water retains its monopoly over use or operation of the infrastructure, section 16 of the 2005 Act requires it to provide water or sewerage services to a retailer's customer where it is requested to do so by that retailer. The contract for that supply will be between Scottish Water and the retailer (rather than Scottish Water and the customer)

and, if no agreement is reached, the retailer may apply to WICS who can determine the terms and conditions required. WICS has used its powers under section 11 of the 2005 Act and included a standard licence condition that, taken together, encourages Scottish Water and retailers to use the template wholesale services agreement that it has published as the basis of such agreements. The template wholesale services agreement covers issues such as metering, charging, service standards, liability, interruptions and other standard clauses such as termination.

In England and Wales, sections 66A, 66B or 66C of the WIA91 compel the incumbent water companies to provide suppliers with water or permit use of the infrastructure for that supply (depending on which type of licence authorisation the supplier holds). As with section 16(7) of the 2005 Act, section 66D(2) gives Ofwat determination powers in relation to the terms and conditions to be agreed between a supplier and the incumbent water undertakers. The supplier must request such determinations.

Section 66D(4) also requires Ofwat to issue guidance on the wholesale terms and conditions. That guidance contains the terms and processes that Ofwat expects each water undertaker to include in the access code that it is required by condition R of its instrument of appointment to produce. Each water undertaker will have its own access code and the guidance states that these access codes should include payment terms including frequency, arrangements for dealing with debt, a service level agreement setting out services to be provided to the supplier and water quality issues. Agreements under sections 66A–66C are known as access agreements and will be made by each water undertaker on the basis of the terms and processes contained in its access code (although the parties may agree some changes, eg where different services levels etc are required).

One further difference between the use of access agreements in England and Wales and wholesale services agreements in Scotland, is that access agreements are roughly customer (or premises) specific whereas the wholesale services agreement made between Scottish Water and a retailer will cover all of the supplies required for that retailer's customers. Recognising the costs involved in negotiating a new agreement for each new customer, Ofwat suggests in its guidance that suppliers should agree a separate wholesale master agreement with each water undertaker, which can then be supplemented with the premises specific details at the time each supply is requested.

Section 66D(8) gives Ofwat the unilateral ability to require changes to any access agreement that it considers not to conform with the terms of its guidance, but Ofwat does not consider its statutory authority to extend to allow a regulatory oversight of the wholesale terms and conditions in the way that has been seen in Scotland.² Because negotiations for

² More specifically, in relation to wholesale master agreements, Ofwat has stated: 'We do not have powers under section 66D(2) of the [WIA91] to determine the terms and conditions of a WMA as this contains only general terms about the relationship between the water

access arrangements must be made with a monopoly company, exerting effective regulatory oversight over them can be a way to reduce the risk of delay or abortive negotiations.

The legal approach to the setting of wholesale charges taken in both jurisdictions also offers some interesting contrasts. Incumbent water and sewerage companies in all parts of Great Britain must produce a charges scheme, detailing the various charges that they will apply for their different services and those charges schemes must be approved by either Ofwat or WICS as relevant. However, the English and Welsh water companies retain a discretion that was removed from Scottish Water with the implementation of the 2005 Act, to charge non-household customers (such as retailers) on an individually negotiated basis. Access charges levied by incumbent water and sewerage undertakers in England and Wales are, broadly speaking, individually negotiated.

Ofwat's determination powers under section 66D include specific provision for determining disputed access charges and Ofwat's access code guidance contains a methodology to be followed in each water/sewerage companies' access codes. There are, therefore, similar safeguards in place in relation to the charging elements of a supplier's negotiation with a monopoly company as with the other terms and conditions. However, Ofwat's interpretation of the 'costs principle' outlined in section 66E of the WIA91 in this context has proved controversial. Legal analysis of the interpretation that Ofwat has taken is outside the scope of this paper³ but it is worth noting Ofwat's comment that '*We continue to believe that the costs principle remains one of the most significant barriers to the development of effective retail competition.*'⁴

The restriction of individually negotiated charging in Scotland⁵ eliminates many of the delays caused by customer specific negotiations and regulator determinations. The Scottish regime is also not bound by the costs principle as outlined in section 66E. The link between Scottish Water's wholesale charges scheme and the charges paid by retailers appears to have supported a competitive retail market in two further ways: first, it supports a transparent retail margin which helps retailers develop their business plans

undertaker and the licensee. But we do have the power, in default of agreement between the parties, to determine the terms and conditions relating to premises specific applications made under sections 66A to 66C of the WIA91'. See s 3.2 of Ofwat's access code guidance dated July 2007.

³ Although for a more detailed consideration, please see the summary by the author of the CAT's judgement in *The Journal of Water Law* 17 (2006) 4 151. Further, a more detailed consideration of Ofwat's application of the costs principle in a 2008 access charges determination will be available shortly on the website and in this journal.

⁴ See paragraph 7.3 of Ofwat's final determination of the terms of wholesale access prices offered by Anglian Water Services Ltd to Aquavita (UK) Ltd to four customers, dated 28 March 2008 and available on Ofwat's website at: www.ofwat.gov.uk.

⁵ Note that some basis remains for individually tailored charging in Scotland, s 29E of the 2005 Act allows Scottish Water to alter its wholesale charges, with WICS's consent, where a customer has done or agreed to do something that reduces or increases the cost to Scottish Water of providing that customer's retailer with services.

accurately and allays concerns about preferential treatment amongst retailers. As Scottish Water's old retail functions and existing customers were transferred into a new subsidiary company (Scottish Water Business Stream), this element was a particularly important way of providing other retailers with a degree of certainty that competition in the market was level and fair. Secondly, it allows a central market system to run which calculates all wholesale charges payable by the retailers, removing the function from Scottish Water's control. That use of a centralised market system is described further below.

MARKET RULES

Using its section 11 powers, WICS developed (in consultation with the industry) a market code and required Scottish Water to establish a 'Central Market Agency' (CMA) to operate the provisions of that code. The market code is essentially a multilateral contract, which each of the retailers and Scottish Water are obliged to agree to via licence conditions and directions made under section 11. It prescribes rules relating to the registration (or switching) of customers between retailers and in relation to the calculation and payment of wholesale charges.

The CMA is a company limited by guarantee, whose membership is made up of the retailers, Scottish Water and WICS. It is funded by Scottish Water and the retailers. The CMA uses the information contained in Scottish Water's annually approved wholesale charges scheme and customer specific information, such as consumption, provided to it by Scottish Water and the retailers, to calculate how much each retailer owes to Scottish Water on, broadly speaking, a monthly basis. The CMA holds the central register of all customers' details but does not collect and distribute the charge payments itself. As agreements between incumbent companies and suppliers are concluded on a bi-lateral basis in England and Wales, there is no comparable arrangement.

The Scottish framework relies on one other multilateral contract, known as the operational code. That contract, again developed using WICS's powers under section 11 of the 2005 Act, contains detailed provision on the processes to be followed for technical operations of the market, such as establishing new connections and reading meters. Again, no such centralised multilateral contract exists in the English and Welsh industry.

CONCLUSION

While there are clearly different logistical and political considerations at play in the two industries, the use of structural separation in Scotland deserves a final mention. Scottish Water's retail functions (including its staff) have been split off and are now controlled by a strongly autonomous subsidiary company, Scottish Water Business Stream Limited. WICS has implemented a number of measures to ensure the true separation of the two companies, measures which were designed to achieve an ostensibly level playing

field. That level playing field is an important component in encouraging competition but more interestingly, the process of separation is allowing Scottish Water, Business Stream and WICS to identify efficiency savings within the supply chain; savings that will ultimately benefit all water and sewerage customers.

The statutory framework for a competitive water market is broadly similar in England and Wales to that in place in Scotland, relying on disaggregation of the

supply chain to preserve monopolies over the infrastructure whilst allowing competition in, roughly speaking, retail functions. However, the Scottish legislation has given WICS a relatively broad remit to facilitate the development of the market and severely restricted the ability of Scottish Water to negotiate wholesale charges individually. This appears to have allowed the Scottish competitive market to avoid many of the difficulties that the English and Welsh industry has experienced.