

# CONSULTATION RESPONSE



Cave Review on Competition and Innovation in Water Markets

14 August 2008

## **Call for Evidence by the Cave Review on Competition and Innovation in Water Markets**

The HBF welcomes the opportunity to provide the Cave Review with comment on how competition and innovation can be taken forward in the water sector.

We would begin by saying that the relationship between developers and the water industry is unique. The water companies have obligations for the supply of water, disposal of sewerage, management of surface water and the alleviation of flooding problems. The house building industry provides these companies with assets from which they derive revenue in perpetuity. As an industry we contribute approximately 4% of the water companies' turnover and the number of new homes constructed last year constitutes 0.7% of the increase in the existing housing stock. In spite of this significant impact on the water industry we have some major issues with regard to the water companies (as was highlighted in a survey of our Members in 2006) which we feel the introduction of true competition into this sector would go a long way to address.

HBF has always advocated the benefits of competition in the utility sector and over the years have contributed to this objective in water, gas and electricity with the respective industry regulator. Our experience in this area has highlighted common incentives and obstacles to the development of competition. Unfortunately our experience with the Self Lay of Water Mains and Service Connections is that water companies have various methods for resisting competition. Similar barriers to competition were encountered by CCWater Business Customers Group in relation to Water Supply Licensing. The result is that competition in the water sector is extremely limited.

We feel it would be helpful to highlight to the Review Team the factors that hindered competition in Self Lay. All of these issues are listed below in no particular order. It has to be said that after four years Self Lay is still seldom used by our members because of the reluctance of existing water companies to promote competition.

- From an institutional and cultural perspective, water companies have never had to compete, so they fear competition and try to resist it.

- There needs to be strong leadership in driving competition and to date Ofwat has found it difficult to influence water companies.
- Voluntary guidance and obligations are rarely adhered to by water companies. If we compare events in the electricity sector: when license conditions were imposed on Distribution Network Operators their attitude to completion changed.
- Even after four years many water companies will not allow Self Lay Organisations (SLO) to undertake certain operations even though the SLO are accredited to do so.
- Some water companies have no procedures in place to facilitate competition and are reluctant to cooperate.
- A disparity exists between the water companies' costs and their charges to undertake Self Lay. There is a lack of transparency on what is being charged as part of the scheme charges or the on costs to the companies.
- Levels of service in the provision of information to compare the regulatory and competitive aspects of Self Lay are voluntary rather than mandatory so delays result in developers not being able to make comparisons on which option to take.

Many of the above issues were discussed with your Mr. Whitmarsh at a meeting in June 2008 and we have enclosed with our response the notes we emailed to him following the meeting which in many ways replicate what is contained in this response.

In relation to the 40 questions in the Call for Evidence, we have compiled our response for those areas affected by house building. We are of the opinion that the Review Team needs to look at development as a separate issue outside the consumer obligations and seek to produce conclusions which are focused only on new build.

The last issue we would raise is that the way the detail is evolved for competition and innovation needs to differentiate between infrastructure and supply/disposal. This will be fundamentally important and should follow the principles of the gas and electricity sectors. The Review Team should be aware that the principles are in many cases self-evident; it is how the detail is formulated that presents problems. Our experience in the water sector is that the detail becomes the obstacle to progression and it also serves to protect the monopoly position held by water companies.



## Questions

**1. Has the development of competition to date in all its forms in the water and wastewater industry (a) delivered keen prices, choice and good service to consumers and (b) supported the efficient and sustainable use of water?**

*No, to date in Self Lay it has in many cases produced the opposite.*

*In relation to wastewater on new build there is no competition.*

**2. To what extent have the current (a) legislative framework and (b) regulatory arrangements supported or hindered the achievement of these objectives?**

*The principles and legislation are in place for Self Lay yet the detail and lack of mandatory obligation for companies to adhere is stopping competition.*

*This is also hindered by a lack of leadership by Ofwat in driving competition forward.*

**3. To what extent could the framework for comparative competition be reformed to better deliver the needs of consumers and the environment without further actual competition? You may wish to provide evidence for the extent to which the regulatory framework could improve outcomes for consumers and the environment by: changing the specification of regulated inputs and outputs; improving incentives for efficiency and investment (e.g. capital versus operating expenditure; regulatory time horizons); making more use of comparisons between companies' performance.**

*The water sector needs to be changed in the way infrastructure and supply/disposal is controlled within companies.*

*For new build it would be beneficial to offer incentives to water companies to compete against each other for the provision of the above.*

**4. What have been the pros and cons of the recent operation of capital market competition? In the light of the present system of comparative regulation and the vertical integration of companies, what (if any) constraints on capital market competition are appropriate? How might capital market competition be rendered more effective?**



*The difficulties of having to deal with more water companies on new developments would be mitigated by the imposition of uniform policies and standards throughout the industry.*

**5. What are the advantages and disadvantages of vertical disaggregation and horizontal aggregation within the industry? *This might involve, for example, a company selling its retail business to another company. Potential areas to consider include: the loss or gain of economies of scale and scope, transactions costs, financing costs and the need to coordinate investment and operations along the value chain – and the impact of these on the objective of sustainability.***

*See answer to Question 4.*

**6. Are inset appointments currently an effective way of delivering benefits to consumers and the environment, and how might they be improved? *Potential areas to consider include: gains to consumers in the form of keener prices and a better service, the more sustainable use of water, risk of inefficient entry, customer eligibility to be supplied by an inset appointee, the inset process and the licensing terms.***

*The HBF sees that Inset Appointments are one of the most effective ways to enable competition to take place in new build. We feel these benefit the consumer as well as the developer. However to date the allocation for new developments has not worked that well with delays inhibiting a greater take-up.*

*We know from our discussions with water companies that this route for competition concerns them and they are aware that it will pose a major challenge to their present status.*

**7. Is there benefit in the greater or even compulsory use of competitive tendering by water companies? *Potential areas to consider are: the impact on the costs of providing services, innovation in the way they are delivered, economies of scale and scope and transaction costs and the need to coordinate along the value chain may be important, as might the pros and cons of compulsion and existing strength of incentives for outsourcing, the scope and the mechanism for imposing such a regime.***

*If competitive tendering is used with an element of common sense it will provide benefits on cost and levels of service.*

**8. Are there barriers to the take up of self-supply? If so, what and how might they be addressed?**

***For example, barriers to acquiring raw water, or taking up alternatives to drainage through the public sewers.***

*No, so long as correct accreditation and standing in relation to health and safety are in place.*

**9. What are the advantages and disadvantages of extending retail services competition for water to all businesses? How could this best be achieved? *Issues could include: impact on prices, service and costs; impact on efficient use of water by customers; influence on network operators/wholesale suppliers; cherry-picking and implications for cross-subsidies; and the need for metering. The phasing of any extension, the maintenance of thresholds, the ability to trade in-area, economies of scope and the process of switching may be relevant to successful implementation.***

*We only see advantages in doing this.*

**10. What are the advantages and disadvantages of extending retail services competition to households? Would the effects be different for different groups of customers? How could the interests of disadvantaged groups be protected? *The UK Government and the Welsh Assembly Government in setting our terms of reference note the importance of protecting in the round the interests of households, and of vulnerable households in particular.***

*With appropriate controls in place and protection for disadvantaged groups it should bring cost benefits to consumers.*

**11. What are the advantages and disadvantages of allowing retail activity competition in sewerage to a) business and b) domestic customers? *Potential issues to consider include: impact on prices, service and costs; cherry-picking and implications for cross subsidies. As with competition in water supply, the impact in the round on households, especially vulnerable ones, is of particular importance to the government.***

*See replies to previous questions.*



**12. How could continuity of supply to consumers be guaranteed? *Issues to consider would be how to allocate customers of a failed retailer, whether there should be a supplier of last resort and how this can be financed, and the role of the special administration scheme.***

*Given that the product remains the same it should be possible to guarantee continuity of supply as happens in gas and electricity. There seems little likelihood that any company would run out of water. All water companies would have to participate in a last resort option. The regulator will always have to balance the degree of competition and the public health/sociological requirements.*

**13. How do you assess the form of competition which has been in operation since April 1 2008 in Scotland?**

*It is too soon to assess how this is working*

**14. What are the costs and benefits of further competition in water resources and water treatment? How could this be accomplished? *Benefits for consumers and the environment, the impact on economies of scale and scope and transaction costs, how to attribute costs and the need to coordinate along the value chain may be important.***

*Again, in theory competition should bring down costs but this needs to be weighed against environmental and social sustainability aspects.*

**15. What are the advantages and disadvantages of extending competition to the other parts of the sewerage value chain, for example, treatment, recycling of water and sludge disposal? How could this be accomplished? *Benefits for consumers and the environment, the impact on economies of scale and scope and transaction costs, how to attribute costs and the need to coordinate along the value chain may be important.***

*See reply to Q.14...*

**16. How best can new entrants gain access to raw and/or bulk water supplies? *Options could include using market mechanisms such as enhancing the current trading regime or divestment; or allocating licences according to a set of criteria determined centrally or by stakeholders.***

*The allocation of licences centrally would seem to be the most practical solution.*

**17. Is it feasible for legislation or regulation to promote or extend the current arrangements for the sustainable transport or trading of raw water?**

Yes...

**18. What are the advantages and disadvantages of pricing raw water to reflect its full social cost?**

**How could retail prices be insulated from any increase in the cost of raw water to suppliers?**

***Considerations here include the more efficient and sustainable use of water; the impact on businesses that use significant amounts of water, and impact on consumer bills especially vulnerable consumers.***

*There seems little point in charging the consumer for the social costs of water if the payment contributes only to the water company's profits. A mechanism for ensuring adequate investment in water conservation, flood defenses etc is theoretically already in place, albeit not enforced.*

**19. Is common carriage (whereby entrants pay for use of the incumbents distribution network) the most suitable model of competition for delivering benefits to consumers and the environment? *Another alternative would be a single buyer model. Issues to consider could include: impact on cross-subsidies and the "universal service obligation", cherry-picking, need to coordinate through the value chain and the more efficient use of resources.***

*Common carriage does seem another area where competition can be looked at and this may also be linked with the use of Insets.*

**20. On what basis should access be priced? *Different methodologies, such as 'retail-minus' or 'cost-plus' will have different implications for incumbents, entrants, business owners and consumers ineligible for competition. Their suitability may vary depending on which services are being accessed, and the nature of the geographic market.***

*Any basis for costing access will be unfair to some stakeholders. The regulator needs to assess the extent to which they can address this inequality.*



**21. How do you appraise these risks, and what steps can be taken to eliminate or mitigate them?**

**How will any development or extension of competition affect the interests of households, and of vulnerable households in particular?**

*The regulator will have to take a view.*

**22. How would different forms of competition impact on the cost of capital and the efficient financing of investment?**

*Competition would change the financial institutes' view on the water companies. At the Source Conference in May held by WaterUK, a number of speakers intimated that changes to the way water companies are conducting their business in the future could bring uncertainty into the markets. This is a concern.*

**23. What objectives does the imposition of such forms of separation support? Which form of separation, if any, is appropriate for which form of competition? Through what process (existing legislation relating to water services or to competition, or otherwise), might such separation remedies be made available to the regulator? Are there issues of timing?**

*There will be different forms of separation appropriate for different forms of competition. The regulator will have to assess how best they can deal with the complexity.*

**24. How (if at all) would the regulated capital value (RCV) be allocated to different elements of the value chain under different forms of separation? *Considerations might include allowing competitive entry, ensuring a sufficient return to efficient investments, neutralizing impacts on final retail prices, impact on investors and how the RCV allocations would be calculated in practice.***

*No comment.*

**25. In the light of your previous answers, what programme for enhancing competition (of whichever model) would you introduce? What would the timing and sequencing of any such programme be?**

**Questions**

*There needs to be a measured approach to how competition will be introduced, or extended in the water sector so the appropriate safeguards are in place to ensure compliance with standards and more importantly health and safety issues.*



**26. To what extent can innovation in the current water and wastewater industry be considered currently to (a) deliver keen prices, choice and good service to consumers and (b) support the efficient and sustainable use of water? How does this compare with other sectors and other countries, and what evidence is there for this? *Examples could include uptake and diffusion of technology and techniques.***

*In relation to new build, the water companies do not introduce any innovation. In fact as an industry we are being asked to drive innovation as part of the Code for Sustainable Homes, not only in the area of water efficiency but also with regard to sustainable drainage (SuDS). Both are at a considerable cost to the house building industry and, especially in relation to SuDS, the water companies are obtaining a benefit in not having to upgrade the existing storm water network to accommodate the management of surface water. It is likely that the costs of future maintenance of many SuDS elements would be less yet the water companies do not wish to adopt them. It is clear that the proliferation of more sustainable drainage options is dependent on a change of attitude. Developers are not merely reluctant to spend more to reduce costs to the water companies but are also having to provide ongoing maintenance facilities on individual developments to overcome the lack of an adoption mechanism. This is particularly irksome given the considerable sums developers also have to pay water companies as 'infrastructure charges'.*

**27. To what extent do the current (a) regulatory or (b) legislative frameworks support or hinder the achievement of these objectives?**

*For new build, the regulatory and legislative framework does not address innovation and is completely at odds with what developers are being required to construct under the planning system. All of which is a cost being borne by our industry.*

**28. Are there innovative technologies, processes and organisational techniques that would benefit consumers and the environment but which have not been adopted? If not, why not?**

*The main one is SuDS which still have unresolved issues around adoption and maintenance. The main problem is that no one wants to take responsibility for them. As previously stated our members have to adapt SuDS for nearly every development to comply with PPS25. All of which has a major financial benefit for water companies. There is no evidence to suggest that the ongoing maintenance of SuDS would cost water companies any more than piped systems and many of the elements are recognized not only as more sustainable drainage options but also as cost-effective ways of alleviating flood risk.*

**29. To what extent would greater competition in or for the market deliver more innovation? *For instance, would separated retail companies be more effective at championing consumers with water companies and suppliers and changing customer behaviour. Another possibility might be a market for water efficient goods and services.***

*If innovation is matched with incentives then how this is factored into competition will evolve over time. At the moment water companies have no financial advantage in using innovation for new build to save water as it will affect their returns. In fact the HBF participated for over 18 months in a Steering Group looking at this with Ofwat and the conclusion was that to incentivise developers to build water efficient homes would not be feasible as the water companies felt that there would not be any change in customer behaviour so water usage would be the same. The way to address their concerns about their profits would be to introduce a stepped tariff system.*

**30. Is there also a need for greater coordination / partnerships between companies and between companies, suppliers and stakeholders to encourage innovation? How can this best be achieved? What are the implications for regulation and competition? *Tackling diffuse pollution to reduce water treatment costs, for example, might require a number of companies to work together with suppliers and stakeholders; whilst the development of intelligent meters may require collaboration between companies to establish a sufficiently wide and secure customer base.***

*This would be a major step forward. To date the water companies remain aloof to matters of partnership because of a lack of confidence in the skills of other stakeholders. On any issue it seems that WaterUK are the people who try to drive partnership. For there to be greater coordination/partnership within the water sector there needs to be a major shift in attitude.*

**31. What role is there for Government over and above competition and coordination in stimulating innovation? *Areas to consider might be: more explicit policy frameworks (e.g. for a lowcarbon economy, water efficiency etc.), the setting of stretching goals and performance standards and public sector procurement.***

*For new build this has been imposed by the Code for Sustainable Homes. Innovation will have to take place to enable developers to meet the higher levels of the Code. There remains significant doubt about consumer acceptance of low water usage measures.*

**32. Should the regulator be given an explicit remit to promote innovation? How could it best achieve this? *Options include requiring or giving companies an incentive to invest in research and development, as other regulators do, and introducing levels of innovation into the comparative competition framework.***

*Yes, the regulator should be given an explicit remit in this area. To date there has been no benefit in the water sector to promote innovation so the water companies only want to be seen to comply with their duties under legislation.*

**33. What has been the impact of the decline in reported level of research and development spending since privatisation? What does this indicate about the pace of innovation?**

*We do not have an answer to this question as we are unaware of the research and development costs.*

**34. In the light of future challenges, could the regulatory and comparative competition frameworks of the industry be reformed to further spur innovation which significantly benefits consumers and the environment, in the absence of market competition? *Recognising that the regulatory and comparative competition frameworks meet a number of objectives, you may wish to provide evidence with regard to: the effects of the 5-yearly business planning and price review cycle; incentives for CAPEX, OPEX and financial efficiency; for service performance; whether penalties and rewards for innovation are appropriate; and specification and monitoring of performance e.g. in terms of inputs and outputs.***

*We feel there has to be a combination of regulation and competition to spur innovation. But it seems difficult to motivate water companies towards innovation or efficiency if they are not given incentives.*

**35. How does the current system of enforcement and licensing by the (a) Environment Agency and (b) the Drinking Water Inspectorate impact on innovation? How could it be reformed? *The approval process, the way outputs are specified and the certainty with which they need to be achieved and the penalty regime may be relevant.***

*Our experience is that the EA and DWI can impede innovation. Our members are particularly critical of the EA's avoidance of responsibility and their reluctance to offer advice.*

**36. How could any increased risks to public health and water quality as a result of competition be managed?**

*There have to be robust standards and accreditation in place to manage health and safety issues surrounding not only water but also sewerage.*

**37. How could any increased risks to supply security, flood or drought management as a result of competition be managed?**

*See answer to Question 36.*

**38. What can we learn from other industries, such as energy or communications, about extending competition and promoting innovation?**

*As we have previously stated the HBF has been involved with promoting competition for many years. We feel that there are valuable lessons to be learned from the ways in which competition has expanded in the energy sector.*

**39. What can we learn from international experience of reform in the water industry?**

*We would imagine there must be considerable expertise available among our European colleagues as well as in other parts of the world. However, other countries have different cultural expectations of their utility sector: Germany for instance has a wider level of state involvement than the UK currently considers politically acceptable.*

**40. How can competition and innovation contribute to government objectives of sustainable development and climate change?**

*We have highlighted a number of issues in our response which addresses this question.*

**Dave Mitchell**  
**Technical Director**



**Notes and Issues raised at the Meeting with Alex Whitmarsh  
about the Cave Review on 27<sup>th</sup> June 2008**

**Background to Competition and Other Issues**

- In nearly all of the Consultations issued in the Water Industry there never seems to be an understanding that House Building is a separate issue than the matters surrounding existing consumers. In essence House Builders are asset providers as well as enabling growth for the companies and should be treated separately. In relation to the Ofwat Consultation on Competition this is definitely the case and it is also worth noting that the commentary does not make any reference to the existing competition in the Self Lay of Water Main and Service Connections.
  
- In relation to competition in Self Lay of Water Mains and Service Connections there is some important lessons to be understood in why competition is not widely taking place:-
  - The companies have placed a number of obstacles in the way to delay or side track competition
  
  - Guidance is seen as voluntary not mandatory
  
  - There is a cultural and attitude problem in companies introducing competition because they are not use to competing
  
  - The companies do not respond to Ofwat e.g. it took over eighteen months for companies to produce Self Lay Policies of which many did not accept Ofwat Guidance on Levels of Service
  
  - Some companies will still not let accredited Self Lay Organisation (SLO) to undertake competitive activities
  
  - In some cases companies have no procedures in place for SLO's to undertake the laying of water main or service connections
  
  - On the issue of cost and charges levied by companies there is a disparity of charges required by companies for an operation which in turn makes being competitive as being unviable for an SLO to lay the water mains in some cases. This is also compounded by the fact that the Asset Payment given to the SLO is not

calculated correctly in relation to the project costs.

- With regard to sewers on new developments there is no competition as Developers design, construct and maintain them up to adoption and pay for the companies to check the design and inspect them as well. This constitutes a unique situation where one commercial organisation gifts another commercial organisation an asset which they obtain revenue from in perpetuity. This is further compounded as under Planning Law Developers are required to attenuate surface water for the plots within the development. Yet in the Price Review the companies are allocated revenues to upgrade their existing sewer network for the attenuation of the plots surface water.
- Another issue which has occurred over the last five years is that some companies try to influence Planning Authorities to place Planning Conditions on developments which requires Developers having to pay for reinforcement and upgrading of their foul sewer network. The advantage of this is that when the issue is in the Planning System it falls outside of Ofwat to regulate on. This is the main reason why companies should not be statutory consultees in the Planning System at Outline or in the Detailed Stage of Planning Application. Although they should be consulted in the Regional Spatial Strategy to enable them to provide infrastructure under Section 94 of the Water Industry Act.

### **So what Opportunities are there for Competition and Innovation in the Water Markets?**

- The only one identified in the Ofwat Consultation is in relation to Inset Appointments. On the face of it this does look a viable option and some organisations have been given that status on a few sites over the last eighteen months. The issue with this will be the companies will try to create barriers similar to Water Supply Licensing and that the issuing of an Inset Appointment needs to be processed quicker by Ofwat.
- Another aspect of competition that could be beneficial to investigate is to make it advantageous for companies to operate outside of their present regulated area. The benefit to the companies is that this will be an opportunity to increase revenue streams and to utilise their expertise to the advantage of the Developer.
- Competition also needs to explore a variety of options which can be utilized by Developers and where companies can be held to account like:



- Mandatory Levels of Service
- Costs which are comparable for a specific task
- Streamlining of administration procedures, generic forms and documentation
  - Over the last eight years the HBF has played an active role in seeking to drive for competition in the Utility Sector. Where true competition takes place in Gas and Telecommunications there is a marked difference with regard to cost and levels of service from what takes place in the Water and Electricity Industries. A reason for this is due to a number of factors but especially in the way that the supply and infrastructure has been separated. The most important consideration of why competition has succeeded is also due to the way the respective economic regulator has driven competition. In relation to the Water Market, to date, in Self Lay it is apparent that the companies seem to have an ability to derail competition and Ofwat seem somewhat powerless in being able to influence the companies to perform. Although effective and focused leadership from Ofwat in driving competition will benefit Developers, subject to whether Ofwat is prepared to confront the companies on certain issues which are fundamentally important to facilitate competition in the Water Sector.

**Ray Farrow**  
**HBF Consultant**  
*June 2008*