Title:
Introduction of an appeals mechanism for Ofwat's proposals to amend codes made under the Water Industry Act 1991
IA No: Defra 1965

Lead department or agency:
Defra

Other departments or agencies:
Ofwat and CMA

Impact Assessment (IA)

Date: 15/11/2016

Stage: Consultation

Source of intervention: Domestic

Type of measure: Secondary legislation

Contact for enquiries:
David Jones

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2014 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
£5.4m	£1.8m	-£0.2m	Yes	Out

What is the problem under consideration? Why is government intervention necessary?

Ofwat will be introducing statutory codes associated with facilitating competitive water markets, as per the Water Act 2014. If businesses want to make an appeal against decisions to amend Ofwat's codes, they would have to go through the lengthy, costly and complex judicial review system. This can delay the operation of competitive markets and the benefits they deliver, while creating financial barriers for smaller businesses considering making an appeal. Government intervention is needed to introduce a new, streamlined fast-track appeal mechanism operating through the Competition & Markets Authority (CMA) to reduce the time and regulatory burden associated with the judicial review appeals system.

What are the policy objectives and the intended effects?

The policy objective is to introduce an appeals mechanism that contributes to the delivery of a coherent, transparent and effective regulatory framework that includes appropriate safeguards for market participants to challenge decisions that might impede the development of well-functioning and fair water markets. The intention is that allowing access to a fast-track appeal process will result in robust regulation that benefits the water industry and potential new entrants through a lower regulatory burden and quicker, more transparent decisions. Allowing the CMA to hear the appeals will also ensure that experts in the regulation of utilities will be involved in the appeal process.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

We considered two options:

Option 1 (the baseline) - rely on judicial review as a route for challenging the legality of Ofwat's decisions on statutory code amendments. This is the "do nothing" option.

Option 2 (preferred option) – introduce regulations that allow market participants that are materially affected by an Ofwat decision the option to appeal to the CMA to challenge that decision. This will introduce a fast-track appeal on the legality and merits of Ofwat's decisions. This will provide more certainty to parties about the costs and risks of launching an appeal. Appeals to the CMA will ensure that experts in economic regulation will hear appeals.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 03/2022

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: ..... Date: .....

Summary: Analysis & Evidence

Policy Option 1

Description: **Baseline/do nothing option: Rely on judicial reviews as the only means to appeal against Ofwat's decisions to change codes.**

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:-15.4	High:-2.1	Best Estimate: -7.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	n/a	0.2	**2.1**
High	Optional		1.5	**15.4**
Best Estimate	0		0.8	**7.4**

Description and scale of key monetised costs by 'main affected groups'

Baseline costs of the current judicial review system have been estimated by assuming that two judicial reviews take place within the first three years of the appraisal period. Cost associated with making an appeal through the judicial review system of £3.5m NPV are incurred by applicants (typically businesses). Costs related to assessing/resolving cases are incurred by Ofwat (£0.3m NPV) and the High Court (£3.5m NPV).

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

The number of future appeals and associated costs are identical to those incurred in the previous ten years (2005 to 2015). The actual number could be higher or lower: we have tested the sensitivity of the results to the assumptions through sensitivity analysis.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 0.4	**Benefits:** 0	**Net:** 0.4	No	N/A

Summary: Analysis & Evidence

Policy Option 2

Description: Introduce regulations to enable a fast track process through the CMA to appeal against Ofwat's decisions to change codes.

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -6.3	High: 15.0	**Best Estimate: 5.4**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A		0.0	**0.2**
High	N/A		0.8	**8.2**
Best Estimate	0.01		0.1	**0.8**

Description and scale of key monetised costs by 'main affected groups'

All costs are incremental to the baseline/option one costs – the costs presented here are central estimates. There are minor, one-off costs to the CMA of £0.01m and ongoing costs related to assessing appeals of £0.32m NPV. Ofwat incur additional costs of £0.07m NPV related to familiarisation and appeal proofing decisions. Businesses incur costs of £0.43m NPV due to an increase if the number of interveners per case and costs associated with merit cases/familiarisation.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0.2	**1.8**
High	0	0	1.5	**15.2**
Best Estimate	0		0.7	**6.3**

Description and scale of key monetised benefits by 'main affected groups'

Incremental benefits are driven by the avoided costs of the lengthy judicial review system (as set out in option one), which is replaced by the new, faster and streamlined CMA appeal process. These cost savings in the central case accrue to: i) Businesses/applicants, £2.8m NPV; and ii) the High Court, £3.5m NPV.

Other key non-monetised benefits by 'main affected groups'

There is an increase in the likelihood of reaching speedier, beneficial decisions and outcomes for the industry and customers through well-functioning competitive markets, due to:

1. Increase in Ofwat's accountability because of a higher risk that its decisions could be challenged due to potential applicants being able to better predict costs and risk of launching an appeal; and
2. Appeals being conducted through a group including experts in utility regulation, as opposed to a High Court judge.

Key assumptions/sensitivities/risks 3.5

The number of future appeals is assumed to be identical to those incurred in the previous ten years (2005 to 2015) in the water and energy sectors. There may be an increase in the number of appeals due to lower costs associated with the appeals process. This has been tested through sensitivity analysis, as reflected in the high cost estimate.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:				In scope of OITO?	Measure qualifies as
Costs: **0.1**	**Benefits:** 0.3	**Net:** -0.2		Yes	Out

Evidence Base (for summary sheets)

Policy background

Introduction

The Water Act 2014 amends the Water Industry Act 1991 (WIA91) by introducing a number of measures to reform the competitive markets in the water sector in England and Wales. Separate impacts assessments[1] were published alongside the Water Bill introduced into Parliament in 2013 to assess the costs and benefits of introducing these reforms.

This impact assessment (IA) considers the case for introducing pro-competitive regulations under the WIA91 to introduce rights of appeal for businesses that are materially affected by Ofwat's decisions to amend or not amend its statutory codes. The main purpose is to consider whether introducing a bespoke, fast track appeal mechanism will reduce costs and deliver benefits to businesses through increased certainty around the time that individual cases will take to be resolved.

Currently anyone wishing to challenge Ofwat's regulatory decisions may be able to apply to the High Court for judicial reviews of those decisions. These can be quite costly and the amount of time taken for cases to be heard can deter some businesses from pursuing judicial reviews. This IA therefore considers whether it would be beneficial to introduce powers for the Competition and Markets Authority (CMA) to hear appeals following a strict statutory timetable against Ofwat's decision to amend or not amend its codes.

For the purpose of this IA we will primarily be referring to codes that will regulate the retail water services market under the water supply and sewerage licensing (WSSL) regime from April 2017. However, this IA is intended to also support any future proposals to introduce appeals to the CMA against Ofwat's decisions relating to any water and sewerage code produced in accordance with, or by virtue of, the WIA91.

Codes

Central to reforms introduced in the WIA91 are requirements on Ofwat to produce statutory codes to regulate arrangements between incumbent water companies (incumbents) and those that want to participate in the reformed competitive markets (entrants).

A number of regimes may be regulated through codes. One in particular is the WSSL regime which enables licensed entrants to use incumbents' networks to provide services to eligible non-household customers in England and Wales.

The intention of codes is to allow Ofwat to make enforceable rules to regulate the activities of market participants (incumbents and entrants) in these markets. In the absence of codes, entrants would face significant barriers to entry. Codes also ensure that there is a level playing field by requiring incumbents to provide the same level of service to entrants as it would for its own associates (i.e. risks around an incumbent showing undue preference for its own business and associates or unduly discriminating against their competitors are addressed).Codes will therefore help to level the playing field and reduce the need for expensive negotiations and make it easier for entrants to compete with incumbents in the reformed markets.

Appeals against Ofwat's decisions to amend codes

The WIA91 also provides the Secretary of State with powers[2] to introduce by secondary legislation regulations that would allow appeals to the Competition and Markets Authority (CMA) against Ofwat's decisions to amend or not amend its codes. In this respect "codes" includes

[1] http://services.parliament.uk/bills/2013-14/water/documents.html

[2] See sections 207A to 207C and Schedule 16 of the Water Industry Act 1991 (as inserted by the Water Act 2014).

those produced to regulate the above regimes and other codes produced *by virtue* of the WIA91 (e.g. if Ofwat is required to produce codes under a licence condition).

The provisions in the WIA91 were designed to introduce regulations that would follow a similar regime already in place in the energy sector; those that are materially affected by a decision of Ofgem to amend an energy code may apply to the CMA for an appeal. The cases are heard by a group of experts in utility regulation that must resolve the case within a timetable set out in the regulations.

Problem under consideration

The overarching issue we are addressing is how we can allow Ofwat to make timely decisions which further its statutory obligations to promote the development of fair markets that provide appropriate levels of consumer protection, while providing regulated businesses with a robust right of appeal.

The reformed water and sewerage markets will be more competitive, but still subject to regulation. Market participants will be required to comply with code provisions if they want to compete in reformed or new water markets.

Codes for the WSSL will be living documents that will be frequently amended, particularly as markets evolve. Changes to legislation, greater customer expectations and advances in technology could also require codes to be amended, revoked or refreshed. This is likely to be the case for the WSSL codes[3], but other codes produced under the WIA91 may be updated less frequently.

Judicial reviews provide a way for the public to challenge some decisions made by public bodies, but it is open to question whether this provides businesses operating in regulated water markets with appropriate rights to challenge any Ofwat decision to amend or not amend a code where they have a significant business interest in the code in question.

Rationale for intervention

Currently if a business or private individual wants to challenge an action or decision of a public body they may make an application for a judicial review of that action or decision to the High Court. In the absence of an alternative appeal mechanism set out in legislation, there is no simple way to get an independent body or person to review a public body's actions or policy decisions.

Judicial review is the main way through which the Courts supervise the decisions of public bodies. However, the scope of judicial review is limited to reviewing the legality of a decision in terms of the powers of the public body in question or the processes it followed to reach that decision, i.e. whether the decision was lawful, rational and fair. In addition the High Court is unable to consider the technical merits of a decision (i.e. its role is not to remake the decision that is being challenged). Uncertainty around the time it takes for the High Court to deliver a judgment also acts as a deterrent for some businesses to launch a judicial review challenge for some decisions even if they stand to suffer financial loss because of that decision.

For public bodies the long wait for the judicial review to be heard and the judgment delivered adds to their costs, could delay the implementation of their decisions and creates uncertainty for other businesses that would otherwise benefit from the decision.

Government intervention is therefore required to introduce a more transparent, faster bespoke appeal mechanism to reduce regulatory burdens by enabling materially affected businesses to challenge Ofwat's decisions to amend its codes. Primary legislation already commits Ofwat to carry out statutory consultations when considering changes to the codes for regulating water markets. Introducing an appeal mechanism through regulations will create a more transparent

[3] Equivalent codes for the water services retail market in Scotland were amended nine times in 2008, seven in 2009, three times each year from 2010 to 2013 and twice in 2014 (source: website of the Water Industry Commission for Scotland).

and efficient decision making process by further incentivising Ofwat to effectively engage with stakeholders on its proposals to amend (or not amend) codes thus enabling it to issue binding decisions that have the support of market participants (i.e. it is more likely to "appeal-proof" its decisions).

Regulations will also provide those wishing to challenge Ofwat's decisions with some certainty about the time and costs involved in pursuing an appeal which will better inform its decisions about whether or not an appeal is worth taking forward.

Making the CMA the appeal body will ensure that experts in utilities will be involved in hearing cases.

Policy objective

The policy objective is to introduce an appeals mechanism that contributes to the delivery of a coherent, transparent and effective regulatory framework that includes appropriate safeguards for market participants to challenge decisions that might impede the development of effective water markets. The intention is that the proposed appeal framework will result in robust, transparent and proportionate regulation that better enables competition in the water industry that benefits customers and reduces regulatory burdens on industry.

In considering options, we want to achieve an appeals process which:

a) supports robust, predictable decision-making whilst minimising uncertainty;

b) provides proportionate regulatory accountability – the appeals framework needs to be able to correct mistakes made by Ofwat;

c) minimises the end-to-end length and cost of regulatory decision-making by making the appeal process as streamlined and efficient as possible; and

d) ensures access to justice is available to all water businesses – not just to the largest companies with the greatest resource and expertise.

Description of options considered (including do nothing)

We considered two options:

- **Option 1 (the baseline)** – The Secretary of State would not introduce regulations and instead rely on judicial review as a route for challenging Ofwat's decisions on code amendments.
- **Option 2 (preferred option)** – Regulations would be made to provide the option for market participants that are materially affected by an Ofwat decision to make an application to the CMA to challenge that decision.

Option 1 would only allow Ofwat to be challenged through a judicial review. This is the "do nothing" option because rights to challenge a public body are already enshrined in law and no Government intervention would be required to implement this option.

Judicial review is a type of court proceeding in which a judge reviews the lawfulness of a decision or action carried out by a public body. In other words, judicial reviews are a challenge to the way in which a decision has been made and is not really concerned with whether the public body made the right decision (unless it was irrational), as long as the right procedures have been followed. The High Court will not substitute what it thinks is the "correct" decision. This may mean that the public body will be able to make the same decision again, so long as it does so in a lawful way. A challenge relating to Ofwat may therefore relate to the way it conducted a consultation or if the applicant believed that the decision was unlawful or irrational, but it would not consider the technical merits of the decision itself. In terms of remedies for a successful judicial review challenge, the High Court is able to issue orders: quashing a decision of a public body; restraining the public body from acting beyond its powers; or requiring the

body under review to carry out its legal duties. Alternatively, the High Court may decide not to make any order but may only issue a declaration that the decision taken by the public body was unlawful or irrational.

Option 2 would require the Secretary of State to make regulations that would allow market participants that are materially affected by an Ofwat decision to make an application to the CMA to challenge that decision. The regulatory framework will be broadly the same as one in place for Ofgem's decisions to make changes to codes regulating energy markets. Appeals would only be allowed where individual market participants would be materially affected by a decision (e.g. if it increases a market participant's costs, affects its market share, makes it less competitive, etc). The grounds for challenging Ofwat's decisions would be much wider than that provided by a judicial review in that the CMA would also be able to look at the technical merits of that decision (i.e. whether it was the "correct" decision). The CMA would also have a wider range of remedies to address its findings beyond that of quashing Ofwat's decision. The CMA could for example direct Ofwat to make a different change to the code or direct Ofwat to either reconsider the matter in line with a direction or make a further determination.

There have been two energy code appeals since 2005, but the applicant in one case withdrew its application. The first case in 2006 (the 2006 appeal) challenged Ofgem's decisions relating to the calculation of cash settlements in the Balancing and Settlement code because the applicant thought the decision was incorrect and insufficient time was given for stakeholders to comment on the decision. This was therefore an appeal based on the merits of Ofgem's decision and the process that was followed in making that decision. Under option one it may only have been possible for the second issue to be considered in a judicial review. However, the application was withdrawn following a request from the Competition Commission for further information on the material impact Ofgem's decision had on the applicant.

For the second case[4] (the 2007 appeal) there was a challenge to Ofgem's decision to reform the gas offtake regime for Great Britain's high-pressure National Transmission System. This involved Ofgem favouring one change proposal over another alternative proposal which made it an appeal based on the merits of Ofgem's decision.

Analysis and evidence

Overall approach

We have adopted a proportionate approach in developing the methodology for assessing the impacts of the proposed changes. This is to reflect that these are minor, permissive changes aimed at better facilitating competitive water markets, and will only have an impact should water market participants choose to make an appeal.

Our approach is based on assessing the costs of introducing and engaging with a new appeals mechanism (option two) against the baseline costs of the judicial review system (option one). We have established the baseline costs, as presented in option one, to inform this process. Hence the estimated savings of option two (generated by a speedier appeals system) **are calculated on the basis of avoided baseline costs.**

It is difficult to predict with any certainty the number of future appeals and associated costs under a new appeals system. Nevertheless, we have monetised where possible the impacts for option two by drawing on historic data and analysis from the energy sector where a similar appeals regime already exists.

[4] See: http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/appeals/energy/final_draft_on_costs.pdf.

It has not been possible to monetise the wider benefits of option two, such as quicker appeal decisions and a more transparent system better facilitating competitive water markets and the associated benefits of delivering greater efficiency and lower prices for customers.

We will be consulting stakeholders on the assumptions about costs and benefits in a public consultation.

Risks and assumptions

Assumptions

This section sets out the main assumptions we have developed for (i) the appraisal period, (ii) number of appeals, (iii) case duration, (iv) number of interveners per case and (v) legal costs. These assumptions underpin our central, low and high cost estimates for both options.

i) Appraisal period

A ten year appraisal period has been selected as reasonable for this regulatory measure and consistent with similar impact assessments. We use historic evidence from the last ten years since cases in the new appointment and variations [5] (NAV) regime and appeals in the energy regimes have all occurred since 2006, though in practice none have occurred since 2011.

The NAV market is an appropriate indicator as Ofwat's past regulatory decisions related to this market have been challenged via a judicial review[6]. The NAV regime allows new entrants to replace incumbent water and sewerage undertakers in unserved areas (e.g. new housing developments on greenfield and brownfield sites). New entrants provide the water and sewerage infrastructure and remain as the Ofwat makes decisions around whether an appointment is appropriate and in the best interests of customers. Two NAV cases arose when incumbents challenged Ofwat's decisions to allow new entrants to replace them as the incumbents for some new developments.

The first energy appeal was launched within two to three years following the appeals legislation coming into force and the NAV cases arose as new entrants started to make an impact in the water market. The time profile of cases arising in both regimes indicates that the appetite to challenge Ofwat's decisions is likely to be greater closer to market opening or when a bespoke appeal route is introduced. For this reason, we have assumed that future cases for both options follow a similar time profile.

ii) Number of appeals

For the purposes of determining the costs and benefits we are assuming the same number of cases under option one and option two. This assumption is based on the number of NAV regime challenges where judicial review is the only way of challenging Ofwat's decisions to grant a new appointment and on the number of market code appeals in the energy sector.

The number of future appeals that arise over the ten year appraisal period can therefore be estimated by drawing on past evidence as displayed in Table 1.The energy market appeals system provides a very useful indicator of the number of future cases as it is similar in scope to the option two proposals. The water and energy sectors also tend to have a significantly lower number of appeals compared to other utilities, such as telecoms. We have used this evidence to develop central estimates of the future number of appeals.

[5] For definition of NAV, see footnote 1.

[6] It should be noted that other decisions unrelated to statutory codes such as changes to licences already provide rights of appeal to the CMA.

Table 1: Evidence underpinning assumptions on the number of the appeals/challenges, central case

Option	Assumed number of appeals	Source
Option 1	2	Two appeals in the past ten years under the NAV regime, in 2009 and 2011.
Option 2	2	Combined evidence on appeals under NAV regime and two appeals to energy market codes in 2006 and 2007.

Source: Defra assumptions based on evidence from the water and energy sectors.

It should be noted that the two future cases assumed under option two should not be interpreted as being in addition to the option one cases. These are the same businesses appealing, but we assume that they would choose to appeal and engage with the new, CMA appeals mechanism under option two.

We can be more confident in our assumptions for option one, given that that the NAV regime has been in place for fifteen years and interpretation of relevant provisions and processes is well established. The last case was five years ago: this trend suggests that it is possible that there will be a lower number of cases than there have been in the past. We have tested the impact of a lower number of future cases (one case) in the 'lower' estimate.

For option two, the evidence on the number of appeals under the energy codes regime provides a very reliable benchmark for our central estimate, but there is a small risk that greater transparency, lower costs and speedier outcomes may result in a higher number of challenges. We test this uncertainty through a wider range applied around the central estimate, with double the number of appeals in the 'high' estimate[7]. A single appeal is assumed in the 'low' estimate.[8] The assumptions for both options are displayed in Table 2.

Table 2: Number of assumed appeals, central, low and high estimates

	Central	Low	High
Option 1	2	1	2
Option 2	2	1	4

Source: Defra assumptions based on evidence from the water and energy sectors.

iii) Case duration

The biggest driver of costs is the amount of time it takes for the High Court to make a judgment: the High Court determines how long a case will take based on the nature of the challenge and the complexity of the case before it. Of the two NAV regime cases, the 2009 case took seven months and 2011 case took thirteen months [9]. A Ministry of Justice paper on judicial review cases[10] between 2007 and 2011 said that:

[8] The WIA91 has a number of appeal regimes involving the CMA. To date, there have been no cases of an undertaker appealing Ofwat's proposed changes to the appointments (licences) of incumbent undertakers. We assume a single case in our low estimate in keeping with our conservative approach and to acknowledge that the code appeals regime will have a different scope to the appointments regime. We also recognise that changes to codes applied by Ofwat may have in the past minimised the risk of appeal/challenge

[9] 2009 case: Welsh Water v Ofwat CO/4719/2009; 2011 case: Thames Water v Ofwat [2010] EWCH Admin 331 and [2012] EWCA Civ 218. Note that the BIS IA 3014 states the length of these two cases as 13 and 21 months: we have updated these estimates based on information provided Ofwat for the purposes of this IA.

[10] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190991/jr-adhoc.pdf

"For cases reaching a final hearing the total average time taken from date lodged to final hearing was around one year. This time has shown a decrease over the years; however this may reflect the fact that longer, more complex cases, have not yet been resolved."

We have used this evidence to arrive at a central estimate of twelve months for the typical duration of a case under the current system and sixteen months for our 'high estimate' and seven months for the 'low' estimate.

Under option two, the CMA will be subject to a strict timetable laid down in the regulation to consider an application and to reach a conclusion within three months. In certain circumstances the regulations will allow an extension of no more than two weeks for the CMA to deliver its decision, which means a typical case would last 2.25 months ('central' estimate) and can last no more than 2.75 months ('high' estimate) in total[11].

iv) Number of interveners

Other parties may "intervene" in judicial reviews or energy code appeal cases where they either support or oppose the matter in question (e.g. in a case under the water appeals regime an intervener that is material affected by an Ofwat decision may support the applicant or Ofwat) . These are known as interveners under options one and two. We have assumed that there are no interveners per case in the central estimate for option one and one intervener per case for option two. This is because there were no interveners in the two NAV regime cases (the two previous judicial reviews in the water sector), but there was one intervener in the energy code appeal case[12]. Given the broader scope of the codes, which affect all incumbents and licensees in the water retail market in the case of WSSL, the potential number of interveners under option two could be higher. The sensitivity of the results to a higher number of interveners - two per case - is tested in the 'high' estimate.

Table 3: Number of interveners per case - central, low and high estimates

	Central	Low	High
Option 1	**0**	0	1
Option 2	**1**	0	2

Source: Defra assumptions based on evidence from the water and energy sectors.

v) Legal costs

Legal costs are influenced by the resources the parties invest in an appeal. Those parties with the largest resources may employ external legal teams while those with fewer resources may use their in-house legal teams, seek *pro bono* legal representation or financial backing from bodies with an interest in the case. For the purpose of the analysis, we assume that the applicants utilise the in-house legal teams available to them.

Cost assumptions for main groups

The five main groups we have analysed cost impacts for are as follows:

1. the '**applicants'** that want to appeal against Ofwat's decision;
2. '**interveners'** that want to become a party to the appeal because they agree or disagree with Ofwat's decision;
3. the **CMA (under option two)**;

[11] See timeline on page 5 at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284420/cc11.pdf

[12] See : https://assets.publishing.service.gov.uk/media/55194bf440f0b6140400036a/eon_final_decision.pdf

4. **Ofwat** as the economic regulator for the water industry; and
5. the **High Court (under option one)**.

We have based our cost assumptions for these groups on a recent BIS impact assessment[13], with the exception of costs incurred by Ofwat which are based on actual cost data provided by Ofwat[14].

In our opinion, the BIS IA provides the best available evidence on unit costs[15] as it has a similar scope to our proposals: it covers introducing new appeals systems in regulated utility sectors including water, and makes a robust, detailed assessment of cost impacts on different groups, including 'low' and 'high' cost estimates based on a wide range of evidence. We have only presented the aggregate cost estimates in this IA, further detail on the underpinning cost elements can be sourced from the BIS IA.

Applicants, interveners and Ofwat

The costs incurred by applicants and interveners are estimated on a monthly basis, while costs to Ofwat are estimated on a per case basis. The difference in monthly costs between the two options are driven by the costs associated with merit cases, which are assumed to be 25% higher than cases considering legal issues only[16]. Merit cases assess whether Ofwat have made the right or wrong decision, while non-merit cases only consider the legality of the decision (the focus of a judicial review). It is possible that non-merit cases could arise under option two – however, we have only considered the higher cost merit cases in our analysis, so our estimates can be regarded as conservative. These costs also capture any additional familiarisation costs that may arise from engaging with new CMA appeals system. Interveners' costs are assumed to be 50% of the main applicants, as per the BIS IA[17].

Ofwat's costs under option two may be higher because of the shorter period of time which it has to prepare for cases and respond to evidence. Ofwat may also incur additional costs to appeal proof its decisions. We have increased Ofwat's costs by 25% to account these potential cost pressures.

High Court/CMA

The High Court costs are estimated at £1.82 million per case[18] regardless of the length of the case. The BIS IA did not consider costs of energy code appeals; the CMA's costs have been sourced from an earlier DECC IA[19] on appeals in the energy sector.

The central, low and high cost assumptions for all groups are displayed in Table 4. These cost estimates, in conjunction with the assumptions set out on pages 9 to12, form the basis for estimating the costs of the policy options.

[13] BIS 0410 impact assessment: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207702/bis-13-924-regulatory-and-competition-appeals-impact_assessment.pdf

[14] We have used specific cost data provided by Ofwat on actual costs incurred under the two NAV regime cases – £150,000 for the central estimate, £100,000 for the low estimate and £200,000 for the high estimate. These estimates have scaled up by 25% for option two to reflect potential additional familiarisation and appeal proofing costs.

[15] ,See Annex C, BIS 0410

[16] See Annex C, BIS 0410.

[17] See Annex C, BIS 0410.

[18] See Annex C, BIS 0410.

[19] DECC 0030: page 10, based on the cost of licence change appeals, adjusted for case duration with the midpoint taken for central estimate. See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/43256/1161-ia-third-package-licence-mods.pdf.

Table 4: Summary of central, low and high cost estimates, £m

Costs	Option 1			Option 2		
	Central	**Low**	**High**	**Central**	**Low**	**High**
Cost to main applicant, per month	**0.16**	0.03	0.24	**0.20**	0.04	0.30
Cost to interveners, per month	**0.08**	0.02	0.14	**0.10**	0.03	0.18
Cost to Ofwat, per case	**0.15**	0.10	0.20	**0.19**	0.13	0.25
Costs per case to High Court (option 1) or CMA (option 2)	**1.82**	1.82	1.82	**0.17**	0.15	0.19

Source: Average costs per appeal: BIS IA streamlining competition and regulatory appeal IA, Annex C. CMA costs based on DECC IA (DECC0030), Ofwat costs based on data provided by Ofwat.

Risks

The risk with option one is that doing nothing would constrain market participants (e.g. smaller incumbents or new entrants) from appealing against decisions to change codes established by Ofwat, particularly if they are smaller businesses due to the costs and complexity of the judicial review system. Businesses that do appeal would face lengthy, uncertain process of the current system. There is a risk that option two could lead to an increased number of appeals within the ten-year period. This is because of the reduced costs and the increased opportunity for those with fewer resources to apply for appeals. However, this has not been the experience in the energy sector where there are much larger markets than we see in the water sector[20] and possibly more to be gained through an appeal. We would also expect businesses opting to appeal to be better informed of the economic case given the greater transparency of the reformed appeals regime. Nevertheless, we have tested the potential for a higher number of appeals through our 'high' estimate (see Table 2).

Monetised and non-monetised costs and benefits of each option (including administrative burden)

Option 1 (the baseline) – The Secretary of State would not introduce regulations and instead rely on judicial review as a route for challenging Ofwat's decisions on code amendments.

Costs

The approach to estimating the baseline costs involves applying the assumptions, as set out on pages 9 to 12, to the cost figures presented in Table 4. At a high level, this means scaling the relevant costs by:

i) case duration – for example, monthly costs to applicants and interveners x 12 months for the central estimate, to arrive at a cost per case.

ii) number of interveners per case – zero per case assumed in the central estimate.

iii) number of cases that arise over the appraisal period – for example, cost per case (including fixed costs to the high court and Ofwat) x two cases for the central estimate.

[20] For example, the retail market for non-household water market will only consist of 1.2 million customers in England and Wales, while the energy market consists of some 50 million customers (household and non-household).

The total cost estimates have been discounted by 3.5% over ten years to give a central estimate of £7.4m NPV for baseline option one costs, as presented in Table 5. The high estimate of around £15m NPV is driven mainly by the longer case duration (sixteen months).

Table 5: Costs of option one, £m NPV, central, low and high estimates

	Central	Low	High
Costs to applicant	**3.65**	0.20	7.29
Costs to interveners	**0**	0	4.26
Costs to the High Court	**3.46**	1.76	3.46
NPV	**7.39**	2.06	15.39

Source: Defra analysis. Note that totals may not add due to rounding.

Benefits

The main benefit of option one is that it covers a tried and tested regime with several precedents. This can provide some degree of certainty. An additional benefit for potential applicants under option one is that there is a three month period from the public body making a decision in which an applicant can decide whether or not to apply for a judicial review. This period is limited to three weeks under option two. This additional time under option one could mean that potential applicants have more time to reflect on the likelihood of winning the case and its appetite for risk. However, these benefits cannot be monetised and are likely to be offset by the longer period of uncertainty for Ofwat and those that support Ofwat's decision.

Option 2 (the preferred option) - Regulations would be developed to provide the option for market participants that are materially affected by an Ofwat decision to make an application to the CMA to challenge that decision.

Costs

There will be set up costs for the CMA regardless of whether there are any cases. These will include one-off costs around preparing appeal rules for cases and guidance for those involved in an appeal. For the energy code regime, the CMA's set-up costs were £11,000. Given that the water regime rules and guidance will be broadly based on those produced for the energy regime, these costs could be a lot less in terms of policy and legal input, but we apply the £11,000 figure in our analysis. The CMA also incurs ongoing costs related to resolving appeals.

The costs to applicants, interveners, CMA and Ofwat will only be incurred if there are appeals made to the CMA. The costs to the parties are ultimately dependent on how costs will be allocated when a case concludes. The losing side is likely to have to cover the CMA's costs as well as the costs of the winning side. If, however, the appeal is partly upheld the costs can be shared. The impact of winning or losing a case on the distribution of costs has not been analysed due to high level of uncertainty and complexity in predicting the outcome of future cases.

The shorter time scales for appeals under this option imply that there will be comparatively lower costs incurred relative to the judicial review process. This is because case duration is a key driver of costs for option one.

The approach to estimating option two costs involves applying the assumptions, as set out on pages 9 to 12, to the cost figures presented in Table 4. At a high level, this means scaling the relevant costs by:

i) case duration – for example, monthly costs to applicants and interveners x 2.25 months for the central estimate, to arrive at a cost per case.

ii) number of interveners per case – one per case assumed in the central estimate.

iii) number of cases that arise over the appraisal period – for example, cost per case (including fixed costs to the CMA and Ofwat) x two cases.

The total costs have been discounted (by 3.5% over ten years) to give a central estimate of around £2m NPV for option two, as presented in Table 6. The high estimate of £8m NPV is driven mainly by the larger volume of cases (four cases) and number of interveners per case (two interveners). Note that these figures represent the absolute cost estimates of option two – the incremental impacts are presented in Tables 7, 8 and 9.

Table 6, Costs of option two, £m NPV, central, low and high estimates

	Central	Low	High
Costs to applicants	**0.85**	0.08	3.13
Costs to interveners	**0.43**	0.00	3.66
Costs to Ofwat	**0.36**	0.12	0.95
Costs to CMA	**1.96**	0.35	8.45

Source: Defra analysis. Note that totals may not add due to rounding.

Benefits

Cases under option two will be heard by experts in regulated markets. Appeals and investigations carried out by the CMA for the regulated sectors are conducted by groups formed from a panel of experts known as a specialist utility group. Specialist utility panel members will be familiar with how regulated markets operate and have a broad understanding of the functions of economic regulators. These specialists could add considerable value to the appeals process (e.g. they can direct Ofwat to make the “correct” change to a code) and would need less reading in time than a High Court judge might need under option one. This may have a twofold benefit:

a) decreasing the time and resources required to appeal a decision made by Ofwat when compared to those required to conduct a judicial review; and

b) better outcomes from the appeals process because the CMA can direct Ofwat to look at the decision again or take into account other factors in order to confirm a decision. There will also be greater accountability around Ofwat’s decision-making processes which will in turn benefit the water sector. Although the benefits of increased accountability are difficult to quantify given that the principal benefit exists in the form of promoting the best outcomes from Ofwat’s decisions to change or not change its codes.

Market participants would be the main beneficiaries if they decide that Ofwat’s decisions are challengeable. Market participants that are materially affected by Ofwat’s decisions will have

access to a fast-track appeal system (under option two) where they could have some certainty around their costs and liability should they lose the appeal.

Table 7 compares the central cost estimates for the two options and also presents whether the different groups incur incremental savings or costs in moving from option 1 to 2, and the magnitude of these. The overall net incremental benefit of implementing option two is around £5m NPV, mostly reflecting the avoided legal costs of a lengthy judicial review that would have been incurred under option one. The summary sheets at the beginning of this impact assessment present the totals of the incremental costs and benefits from this and the following tables 8 and 9.

Table 7: Difference in costs between option one/ two, central estimates, £m NPV

	Option 1 costs	**Option 2 costs**	**Incremental savings (benefits)**	**Incremental costs**	**Net impact (NPV)** (costs treated as negative)
Applicants	3.65	0.85	2.79	0	**2.79**
Interveners	0	0.43	0	0.43	**-0.43**
Ofwat	0.28	0.36	0	0.07	**-0.07**
High Court	3.46	0	3.46	0	**3.46**
CMA	0	0.32	0	0.32	**-0.32**
Total	7.39	1.96	6.25	0.82	**5.43**

Source: Defra analysis. Note that totals may not add due to rounding.

Table 8 displays whether groups incur incremental costs or benefits, and the magnitude of these, for the 'lowest' benefit scenario. This is based on assessing the impact of the high cost assumptions for option two (see Table 6) against the low cost assumptions for option one (see Table 5).

Table 8 : Break down of cost/benefits for 'lowest' benefit scenario (option 1 low costs vs option 2 high costs), £m NPV

	Incremental benefits	Incremental costs	Net impact
Applicants	0	2.93	-2.93
Interveners	0	0.85	-0.85
Ofwat	0	0.71	-0.71
High court	1.76	0	1.76
CMA	0	3.66	-3.66
Total	1.76	8.15	-6.39

Source: Defra analysis. Note that totals may not add due to rounding.

Table 9 displays whether groups incur incremental costs or benefits, and the magnitude of these, for the 'highest' benefit scenario. This is based on assessing the impact of the low cost assumptions for option two (see Table 6) against the high cost assumptions for option one (see Table 5).

Table 9: Break down of cost/benefits for 'highest' benefit scenario (option 1 high costs vs option 2 low costs), £m NPV

Source: Defra analysis. Note that totals may not add due to rounding

	Incremental benefits	**Incremental costs**	**Net impact** (costs treated as negative)
Applicants	7.21	0	7.21
Interveners	4.20	0	4.20
Ofwat	0.26	0	0.26
High court	3.46	0	3.46
CMA	0	-0.15	-0.15
Total	15.19	-0.15	15.04

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Sensitivity analysis

The impact of different cost assumptions and alternative assumptions on the number of cases, interveners and case duration have been tested through our 'low' and 'high' estimates for each option. The figures in Table 10 provide an indication of the 'lowest' and 'highest' possible outcomes by combining the 'low' option one cost estimate with the 'high' option two cost estimate; and 'high' option one cost estimate with the 'low' option two cost estimate. This gives a range of -£6m to £15m. These estimates have been used as the 'low' and 'high' net benefit estimates in the option two summary sheets.

Table 10: Sensitivity analysis – 'lowest' and 'highest' net benefits scenario, £m NPV

	Central	Lowest	Highest
Option 1	7.39	2.06	15.39
Option 2	1.96	8.45	0.35
NPV	5.43	-6.4	15.04

Source: Defra analysis. Note that totals may not add due to rounding.

Direct costs and benefits to business calculations (following OI3O methodology)

The option two changes are permissive: a business (incumbent water companies and new entrants materially affected by an Ofwat decision) incur costs under option two if they make a decision to launch an appeal or apply to intervene in an appeal. These businesses will make a commercial decision on whether or not to appeal based on the risks or opportunities to their individual businesses. We have treated the costs/cost savings to businesses as direct under both options, also assuming that Ofwat and CMA would pass on costs to businesses. For option one, there are estimated costs to business of £0.4m per year (£4.07m NPV); and under option two there are estimated savings of £0.2m per year (£1.84m NPV).

Small and medium business assessments

Small and micro-businesses that are incumbent water companies or new entrants are in scope of the proposed changes, but are very unlikely to be directly affected as they have a minor record of appealing regulatory decisions[21].

However, option two will introduce a fast track appeal process and increase opportunities to challenge Ofwat's decisions, which minimises the costs of an appeal. Since small and micro-businesses are in scope, and if they were to appeal or intervene, they would benefit from option two.

Summary and preferred option

Option one (do nothing) does not require any Government intervention or set up costs for Ofwat or the CMA. Rights to apply to the High Court for a judicial review is enshrined in UK law and is available to any person that wants to challenge an action or decision of a public body within three months of that action or decision. Option one is therefore available to anyone with an interest in the water industry whether or not they are materially affected by the action or decision. However, a judicial review can only look at legal issues around the action or decision, not at the merits of the decision itself.

This along with the lack of certainty around the length of time for a judgment to be delivered and the associated costs is likely to deter most businesses from challenging Ofwat's decisions even

[21] See footnote 5 in BIS IA 3014.

if they could be materially affected by the decision. Ofwat and those that would benefit from the code change would experience a prolonged period of uncertainty not only from the three month window in which a person may make an application to the High Court, but also the period before a judgment might be made.

Option two (the preferred option) would require the Government to introduce regulations that would establish a right to appeal to the CMA on the merits and legality of Ofwat decisions around amending codes. This provides businesses that can demonstrate that they are materially affected by an Ofwat decision with a clear idea of the time an appeal will take and therefore provide them with sufficient information to decide on whether a case is worth pursuing. While a potential applicant has less time to decide whether to apply to the CMA for an appeal than it would to the High Court for a judicial review under option one (three weeks), the applicant would have greater certainty around the length of time a case will take and a clearer understanding of its costs.

The appeal under option two will be heard by CMA experts drawn from the specialist utility panel. The CMA will also have the discretion to resolve the matter quickly by directing Ofwat to make a different change to the code or direct it to either reconsider the matter or make a further determination. These powers are not available under option one.

The preferred option is therefore option two. This supports our policy objective to introduce an appeals mechanism that contributes to the delivery of a coherent, transparent and effective regulatory framework that includes appropriate safeguards for market participants to challenge decisions that might impede the development of effective and fair water markets.

Implementation plan

Subject to the outcome of a public consultation, the Government will lay regulations subject to the affirmative procedure before Parliament in January 2017. If Parliament approves the regulations they should come into force in time for the opening of the WSSL market.

Thereafter the Regulations may be amended so that Ofwat's proposed changes to codes developed for other water competition regimes can also be appealable. However, the Secretary of State may only extend the right of appeal to other code regimes following a statutory consultation with Ofwat, the Welsh Ministers and others that have an interest in the codes.

As required by the Small Business, Enterprise & Employment Act 2014, the regulations will include a duty on the Secretary of State to review the regulations within five years of the regulations coming into force and every five years after that.