The Importance of a Level Playing Field for the English Water Market
Contents

Introduction 3
Context 4
Key issues - separation and compliance, and wider issues facing water companies 7
Summary and conclusions 11
Appendix 1 - Brief case studies on Level Playing Field from other utilities markets: GB Gas 12
Appendix 2 - Brief case studies on Level Playing Field from other utilities markets: GB Electricity 13
Appendix 3 - Brief case studies on Level Playing Field from other utilities markets: Scottish Water 15
Introduction

This paper is one of a series of thought leadership pieces being produced by Gemserv to support the development of stakeholders’ plans for the reform of the water market, in line with Government policies contained in the recently passed Water Act 2014.

Other papers have dealt with the structure and issues associated with governance arrangements at market level. This paper focuses on the requirements for a Level Playing Field between incumbent water companies and new entrants, and will discuss three areas:

- Context - what is a Level Playing Field, and how does it fit with the English water and waste market?
- Key issues - separation and compliance, and wider issues facing water companies; and
- Action Plan going forward - the implementation

The paper is informed by Gemserv’s experience of similar issues in other markets. Appendices to the paper briefly set out the context and arrangements applied in other markets to achieve a level playing field, which may have some read-across for the English water market arrangements. Three examples have been selected: Appendix 1 describes the GB gas market; Appendix 2 the GB electricity market; and Appendix 3 the Scottish water market.
Context

WHAT IS MEANT BY A LEVEL PLAYING FIELD?

Definition and key components

The phrase “Level Playing Field” can be defined in many ways, for example:

- “A Level Playing Field is a concept about fairness, not that each player has an equal chance to succeed, but that they all play by the same set of rules”.
- “A situation that is fair to all; a situation where everyone has the same opportunity”.
- “A situation in which none of the competing parties has an advantage at the outset of a competitive activity because of the rules of the market”.
- “Economic and legal environment which all competitors, irrespective of their size or financial strength, follow the same rules and get equal opportunity to compete”.

In situations where competition is being introduced into previously monopolistic markets, it is essential to create the right market conditions to attract new entrants to enter the market and promote competition on fair and equitable terms. Establishing a Level Playing Field may require rules to be set to enable new entrants to gain a footing until competition is functioning; these rules need to evolve to reflect market developments.

In utility markets, whilst arrangements can be made to introduce competition at the retail and resource ends of the value chain, the core network activities (whether that relates to pipes or wires) usually remain a monopoly function and need to be made available for all market participants in a non-discriminatory manner. The main questions which need to be answered for services provided by a monopoly network provider are:

- Which services will be made available to market participants, including incumbent water companies’ retail arms?
- At what price?
- At which service levels?

In order to design and implement a Level Playing Field, legislation and regulation are key components and form the framework for the market. The role of Government departments and sector regulators is central to shaping an appropriate framework for the market in question.

Competition authorities and legislation

Competition authorities are also key stakeholders. They police the overall framework for competition in the economy and may play a critical role in a situation where a party brings a complaint against alleged discriminatory behaviour, or where an inquiry is held following a referral under relevant legislation.

Key pieces of economy-wide competition law within the UK are the Competition Act 1998, the Enterprise Act 2002, and the Enterprise and Regulatory Reform Act 2013. The Competition Act protects against abuse of a dominant position in a market. The Enterprise Act contained provisions to ensure effective competitive market operations. The Enterprise and Regulatory Reform Act established a single Competition and Markets Authority (CMA), which streamlined and strengthened the competition tools to address anti-competitive behaviour.

The Competition Act Chapter II deals with the abuse of a dominant position by a firm who uses practices such as:

- Predatory prices;
- Excessive prices;
- Refusal to supply;
- Vertical restraints;
- Price discrimination to maximise profit, gain competitive advantage or otherwise restrict competition.

Both the newly established CMA, which is taking over functions from the Competition Commission and the Office of Fair Trading, and sector regulators such as Ofwat, have the power to prosecute firms who engage in these practices, and are able to levy fines of up to 10% of annual UK turnover for every year in which a violation has taken place, up to a maximum of
three years. Ofwat has recently demonstrated the use of its competition powers in a case involving Bristol Water’s developer services activities.¹

HOW DOES THIS FIT WITH THE ENGLISH MARKET?

The first moves to introduce competition in the English (and Welsh) water market date back over ten years, with three methods of introducing competition:

• The inset appointments/authorised appointments regime;
• The Water Supply Licensing regime (“WSL”); and
• Self-Lay Organisations (“SLOs”).

Inset appointments

An inset is best described as the replacement of one authorised undertaker by another to supply all the services of a water undertaker in a designated supply area. Level Playing Field issues arise in the potential provision of water resources, and carriage charges to a newly appointed undertaker’s customers. These issues were tested in a long running court battle between Albion Water and Dwr Cymru at the Competition Commission Appeal Tribunal. The case was finally settled in 2014.

Water Supply Licensing

The Water Act (2003) introduced a limited amount of competition into the water market for England and Wales via introduction of the WSL regime. The WSL regime allows Retail or Combined Licensees to purchase (or bring their own) wholesale supply from an appointed water company, and supply the premises of its customers.

The key features of the WSL regime are:

• The WSL only relates to water. No wastewater business customer accounts can be switched; and
• Only businesses with an annualised consumption of 5ML or greater (reduced from 50ML in 2011) in England, or 50ML or greater in Wales, can switch to a new licensee.

The regulatory obligations that appointed water companies must comply with in relation to the WSL are set out in the licence Conditions of Appointment. Of particular importance regarding the Level Playing Field is Condition R:

• Condition of Appointment R states that an Appointed Water Company (AWC) must maintain an Access Code which sets out its procedure for dealing with requests to switch a customer under Water Industry Act ’91 sections 66A-C. Condition R also contains clauses on Anti-Competitive behaviour, and Obligations about Information.

Self-Lay Organisations

Providing new connections to water company infrastructure is another existing area of competition in the water and sewerage sector. In this market, accredited SLOs are able to compete with water companies to lay certain water infrastructure. The arrangements raise a number of Level Playing Field issues, which have been tested in the case previously referred to involving Bristol Water and Ofwat.

2017 retail market

The Water Act (2014) will lead to the introduction of full retail competition for all non-household customers in England in April 2017, and the subsequent introduction of upstream competition from 2019. The Welsh Government has decided not to introduce

¹ See, for example, Ofwat information paper: http://www.ofwat.gov.uk/regulating/casework/prs_web2140520brlslobrief.pdf
further competition, although there are provisions in the Act for a later expansion of competition in Wales to premises below the currently applicable 50ML threshold.

Late amendments to the Water Bill were added to allow provisions for retail exit, subject to agreement by the Secretary of State. A Defra consultation on the process to be followed in considering any application for retail exit will be published later in the year.

To create conditions for a successful retail market, in which new entrant retailers are able to compete on equal terms, there is much to do at the legal, regulatory and organisational level ahead of April 2017.

The details for how the new market will work are beginning to be driven out by the Open Water programme, which was set up by Defra to deliver the new market arrangements.

Ofwat will be responsible for delivering the governance for the new market, including providing any further guidance on the Level Playing Field.

Ofwat is also actively working on separate price limits, which will set the level of gross retail margin allowed for the contestable retail market. This will allow the construction of separate profit and loss statements for the wholesale, retail contestable and non-contestable businesses. It can be expected that Ofwat will issue updated accounting and transfer pricing rules (revisions to RAG4 and RAG5 rules\(^2\)).

\(^2\) RAG = Regulatory Accounting Guidelines
RAG 4 = Definitions for the regulatory accounting tables
RAG 5 = Transfer pricing in the water and sewerage sector
http://www.ofwat.gov.uk/publications/rags
Key issues - separation and compliance, and wider issues facing water companies

In other utilities markets, as part of the drive for a Level Playing Field for new entrants, legislation and/or regulatory actions have specified the need for legal or organisational separation of incumbent players’ retail and wholesale/ network businesses. Separation has been engineered in different ways, and at different stages of development, in other markets. In a number of utilities, this process has evolved from limited to progressively more comprehensive requirements (see Appendices 1, 2 and 3).

In water, the existing WSL regime does not require separation, but requires compliance with licence conditions and related Ofwat guidance documents.

The new Water Act does not require legal separation, following considerable debate, but does place an onus on Ofwat to ensure that no undue preference is given to incumbent retailers in the new market arrangements.

The decision by Government not to require the full legal separation of the distribution and retail activities of the incumbent water companies produces two potential risks for water companies:

- that new entrants will claim to be discriminated against by incumbent wholesalers who may in some way favour their own retail businesses; and
- that for new entrants, undue preference will be shown to incumbent retail businesses.

Ofwat has taken the first steps towards requiring the organisational separation of the businesses via its work on the PR14 price controls, by requiring separate price controls for retail and wholesale activities. Gemserv supports this and has previously argued in responses to price control consultations that separate and transparent price controls are an essential building block for competition.

Ofwat has already defined the scope of the retail operation for the purposes of PR14 activities. However, we consider that some additional guidance might benefit water companies who are presently at different stages in their preparations for separation of their business units. We believe a methodology or checklist could provide guidance on the steps that need to be taken to encourage the organisational separation of incumbent water companies’ retail and wholesale businesses, bringing benefits of ensuring transparency and confidence in the market.

It is also likely that licence conditions in the new regime will reflect the need for no undue discrimination, and the need to ensure no undue preference is given towards water companies’ own retail businesses.

COMPLIANCE RISKS AND ISSUES

Water companies face a new business environment, where it will become essential to manage compliance risks and limit the chances that employees and contractors act in a way which exposes them to risks. This will be especially important when responding to external requests by new retailers and in time new upstream providers, who will be looking for fair and equal treatment in the provision of services, the price of these services and the service levels. Companies will have to be compliant with all relevant legislation, including the Water Act 2014, and Competition Act 1998.

Appointed water companies will need to ensure their wholesale operations are:

- Providing an equivalent range of services to new entrants and their own incumbent and associated retailer companies
- Non-discriminatory regarding access prices and other costs e.g. costs of connections, metering costs etc.; and
- Providing an equivalent service level to new entrants, showing no undue preference to in-house retailers or associated licensees.

Appointed water companies will need to address a whole series of internal issues, including what the new market arrangements will mean for:

- organisational structures;
- processes;
- data ownership and access;
- IT;
• finance, including financial and management accounting;
• people;
• communications towards customers; and
• office space requirements.

A balance will need to be struck between the needs of compliance and the costs of implementing change. Choices will exist in this respect for each of the items listed above.

Specifically, water companies will need to determine just how separate retail and wholesale, and how separate the non-household business activities, need to be; also what timescales are needed in order to achieve sufficient separation to mitigate the risks of non-compliance.

Two possible early actions which companies may wish to consider are:
• separating their activities supporting non-household customers into an organisational unit and location; and
• the construction of “Chinese walls” information barriers to prevent exchanges of information which may breach commercial confidentiality.

COMPLIANCE WITH NEW MARKET DESIGN AND OPERATIONS

In addition, water companies will be required to be compliant with the new market arrangements being developed by Open Water regarding the market design, processes and data exchanges. These will be contained in a new market code or codes, and operational code(s) which are yet to be developed. Licences may be used to bind companies to these codes, meaning that non-compliance with codes may be a breach of licence conditions.

Of particular importance will be the requirement to ensure that companies’ implementation plans are ready for inter-operational testing six months before market opening i.e. by October 2016. Precedents in other markets have seen companies who are not ready for the new market being fined by the regulator, or have other restrictions placed upon operations out of area, until in-area readiness is in place.

OFEWAT GUIDANCE, LICENCES AND CHOICES FACING APPOINTED WATER COMPANIES

Further guidance is expected to be issued by Ofwat on its expectations regarding a Level Playing Field, supplementing its previously issued discussion document on this subject, “A level playing field for the water market”, September 2013. Water companies have indicated that they would welcome further advice on the activities that need to be undertaken and that these need to be proportionate and take account of the substantive differences in size and scope (e.g. large WASCs vs small WOCs).

Whatever is contained within the guidance issued by Ofwat and the subsequent new licence conditions, companies need to take their own decisions on the extent to which some separation of their retail and wholesale activities is sensible in order to demonstrate that their contestable retail activities are being conducted at arm’s length from their wholesale operations. Water companies will have choices to make regarding the extent to

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3 The England and Wales market is characterised by Water and Sewerage Companies (WASCs) and Water Only Companies (WOCs). WOCs are generally smaller scale companies than WASCs.
which they implement separation of activities and the timescales for doing this; there will be a trade-off to strike between separation costs and the ease of demonstrating the operation of arm’s length relationships to stakeholders, including new entrants and regulatory authorities.

Companies need also to bear in mind that compliance issues are important to address in today’s market, as well as that for 2017, given the need for compliance with the existing WSL obligations and regime.

Each appointed water company will have its own unique position to assess. However, in the opinion of Gemserv, it seems that a clear organisational separation of Retail and Wholesale functions has the following merits:

- Helps water companies align their operations with the new market, which is structured on the basis of retail and wholesale activities;
- Protects against potential legal action/ mitigates the risk of non-compliance fines;
- Protects against potential reputational damage in the event that legal or regulatory enforcement action is taken;
- Helps water companies demonstrate to new entrants they take seriously their obligations;
- Assists in briefing staff on their responsibilities;
- Helps in communicating with customers who does what in the new market;
- Gives focus to those parts of the business and can lead to better outcomes for both the retail and wholesale activities; and
- Allows wholesale activities to be further developed in readiness for changes proposed for 2019 and beyond without unduly impacting on the retail part of the business.

Business models lacking full separation or virtual separation may be possible, but the case to prove that non-discriminatory behaviour is not operating would be more onerous, and potentially open to challenge by both new entrants and the regulatory authorities.

AREAS OF PARTICULAR CHALLENGE: EXPERIENCE FROM OTHER MARKETS

From Gemserv’s experience in other markets, the most difficult areas, in terms of Level Playing Field, include cost allocation (and related challenges on “margin squeeze”), the issues around IT and information protection, and ensuring that employees understand and can operate appropriately in the new environment.

Regarding cost allocations, new entrants will be keen to ensure that appointed water companies comply with regulatory guidance, that incumbent retailers bear an appropriate proportion of costs and that there is no cross-subsidy in place benefitting incumbents’ retail businesses. This was a particular issue in the electricity market, where new entrants successfully challenged the insufficiency of charges made for shared corporate services towards incumbent retail businesses (see Appendix 2).

Linked to this, particularly difficult issues arise over the extent to which IT should and can be separated, or run independently, and the timescales and costs involved in achieving full separation. Choices will exist over whether new, separate systems should be developed, against the re-engineering of existing systems in a shared service environment, to ensure appropriate access controls, and protection of retailers’ commercial information. New entrants in other markets have challenged the adequacy of protection of their information from leakage to incumbent retailers, and any perceived unfair advantage gained by incumbents operating in an integrated systems environment.

In relation to employee understanding, this can be a particular challenge, particularly in a market where competition has not previously existed. Employees impacted by the introduction of competition need to be briefed on their new roles and how they need to operate in the new market.

Compliance issues may arise from employees making mistakes in their dealings in the new market (“sleep-walking into non-compliance”), rather than any explicit attempt to discriminate.

New entrants will play a critical role in challenging arrangements put in place by appointed water companies, and it is possible that they will mount compliance challenges, even to the extent
of taking legal action if they feel they have been subject to discriminatory behaviour. The precedent has already been set and further challenges could occur if incumbents do not adequately address the need for transparent separation of activities. This can give rise to the danger that the market could be brought into disrepute, and damage the confidence of consumers, new entrants and investors in its operations.

**ACTION PLAN GOING FORWARD - THE IMPLEMENTATION**

Given the above discussion, and drawing upon experience elsewhere, Gemserv believes that the following actions should be undertaken (if not already underway) by appointed water companies to address the Level Playing Field challenges facing them:

- Creation and implementation of an organisational design consistent with the new market environment;
- Development and implementation of an effective internal compliance regime; and
- Development and implementation of a market readiness programme, that addresses both retail and wholesale aspects.

Board level engagement in appraising and in governing such arrangements will be needed.

Whilst there is much detail to be driven out in addressing the issues arising, we provide below some views on some of the necessary components and elements to be addressed in each of these.

**Organisation design**

Key issues to be addressed include reviewing the different organisational options needed to ensure compliance with existing and new market arrangements, and setting up the new structures and interface. Most critical is the need for communications on the changes and new environment with team members.

**Compliance regime**

There are a series of potential actions around the establishment of a compliance activity, including compliance officers, compliance codes, monitoring and statements. Critical issues include conformance with Ofwat decisions on separation and cost allocation, and the protection of commercially confidential information. Employee communications on the new arrangements will be an essential element.

**Market Readiness programme - 2017**

A full programme, designed to ensure the company is ready and able to fully engage with the new competitive market, will be needed. As in the complementary components of organisation design and compliance, employee communications on the changes and work programme are an essential foundation. Workstreams will range across all business functions, so an overall multi-functional programme will need to be designed. Key activities will include the development of wholesale tariffs and retail default tariffs, the development and accession to any legal agreements and codes and a full programme addressing the processes and systems needed for market opening and inter-operation. Within the development of a work programme, identification of the critical path for key activities is needed. In constructing this, companies will be alert to the need to be fully ready for industry testing activities in October 2016, six months before market opening.
Summary and conclusions

This paper has highlighted the importance of establishing a Level Playing Field for existing and new entrant water companies in advance of the new market establishment. It seems clear that current water companies will need to address the issues set out in this paper in order to demonstrate their compliance with existing and new regulatory and market arrangements, and to manage the serious risks associated with non-compliance. Choices exist regarding the contents of organisational design, compliance regimes and market readiness programmes in this respect. Whilst some additional information may be forthcoming from Ofwat, and from licence and market codes developments, it is clear that ultimately the buck will stop with the companies and a proactive stance towards these issues is advisable.
Appendix 1 - Brief case studies on Level Playing Field from other utilities markets: GB Gas

EVOLUTION OF COMPETITION IN GAS

- 1987: The market for Large business customers > 25,000 therms\(^4\) opened
- 1994: The market for Medium business customers > 2,500 therms opened
- 1996-98: Small business and residential customers’ market regional pilot areas opened
- 1998: Small business and residential customers’ market fully opened

SEPARATION AND COMPLIANCE

Faced with this hostile business environment, British Gas decided to reorganise its business and implement full legal separation of the transportation and trading businesses. Five new national businesses were created to replace the previous regional and district integrated businesses. Over a two year period, full legal and organisational separation was implemented, and a strong compliance regime applied to the businesses. A new entity, British Gas Trading Ltd was created as the holding company for the four trading businesses, and a Transco business unit established.

Some features of the separation and compliance regime were:

- Separate Board and management for the businesses;
- Appointment of a Compliance Officer reporting to the plc Board;
- Publication of a compliance code;
- Annual compliance statement;
- Full separation of people, using separate buildings;
- Training for employees on expected behaviour, especially communications with other market players;
- Full separation of IT, databases;
- Cost allocations and separate accounting;
- Separate branding for British Gas and Transco; and
- Establishment of Transco Network Code - the market rules.

DEMERGER

After a period where compliance arrangements were in place to keep the transportation and trading elements of British Gas separate, in 1997 British Gas plc decided to demerge its trading businesses and create two new plcs - Centrica plc for trading, and BG plc for Exploration and Production, including the Transco business unit. Subsequently Transco was separately demerged into Lattice plc, which merged in 2002 with National Grid.

COMPETITION REVIEWS AND REFERRALS

During the late 1980s and early 1990s, the market for large business customers opened but very little activity occurred. Following complaints by new entrants and business customers frustrated by the failure of competition, and the alleged anti-competitive practices used by British Gas, a series of Ofgas, Office of Fair Trading (OFT) and Monopolies and Mergers Commission (MMC) reviews occurred. A range of regulatory intervention measures were applied to the dominant, vertically integrated player British Gas. Despite a series of undertakings given by British Gas to the OFT, complaints continued, resulting in a major inquiry by the MMC in 1993.

The 1993 MMC inquiry into the gas market found against British Gas and resulted in two main conclusions:

- There should be complete legal and organisational separation of transportation and trading functions of British Gas; and
- Competition should be introduced into the residential sector by 2000.

In practice, the regulator and the Government advanced the further introduction of competition faster than recommended and the market was fully open by 1998.

\(^4\) 1 therm = 29.3kWh
Appendix 2 - Brief case studies on Level Playing Field from other utilities markets: GB Electricity

EVOLUTION OF COMPETITION IN ELECTRICITY

- 1990: The market for Large business customers > 1MW opened
- 1994: The market for Medium business customers > 100kW opened
- 1998-99: Small business and residential customers’ market fully opened

SEPARATION AND COMPLIANCE

In the electricity market, the regulator did not enforce separation of the Public Electricity Suppliers (PESs) on the initial opening of the business electricity market. Indeed, partly reflecting the lack of definitive legislation underpinning the 1998 electricity market, OFFER was not able to enforce a full legal separation of the retail and wires business units in advance of the full opening of the residential electricity market in 1998. Licence obligations were placed on market parties regarding non-discriminatory behaviour. Requirements to ensure a Level Playing Field did involve operational separation of the units, but there was a relatively tolerant approach to shared services as long as protections were in place to ensure protection of new entrants’ commercial information. The arrangements for 1998 did require appointment of a compliance officer and the establishment of a compliance code, partly reflecting the arrangements put in place in the gas market. However, new entrants felt that these arrangements were lighter and looser than in gas, which gave rise to a series of challenges.

In the early years of market opening new entrants believed that due to integrated systems being in place in a number of companies, they received an inferior service to that enjoyed by the incumbent retailer.

Some features of the separation and compliance regime in the PESs were:

- Separate management for the businesses;
- Appointment of a Compliance Officer reporting to the plc Board;
- Publication of a compliance code;
- Annual compliance statement;
- Voluntary separation of people, not always using separate buildings; access systems to separate areas were typical;
- Passwords and other access arrangements for IT;
- Cost allocations and separate accounting - but with a flawed implementation;
- No requirements for separate branding;
- Establishment of the Master Registration Agreement - the market rules driven out under an industry wide programme (the 1998 Programme); and
- Bilateral agreements between distribution businesses and new entrants; no legal agreements in place internally.

In particular, there was a challenge from new entrants over the cost allocations operated by the incumbent companies. The focus of debate concerned the extent to which the costs of common services provided to both units were correctly allocated. Following a review by the (then) regulator OFFER, many millions of pounds were reallocated from distribution into the retail businesses.
MERGERS AND ACQUISITIONS

The vesting arrangements for privatisation involved the creation of new private generators (National Power Powergen and Nuclear Electric), and the creation of 14 regionally based Public Electricity Suppliers (PESs), which were integrated retail and distribution companies. During the mid to late 1990s, a series of takeovers were made by the generators of some of the regional electricity companies, thereby creating vertically integrated players, which subsequently moved into gas. These takeovers included the acquisition of East Midlands Electricity supply business by PowerGen, of Midlands Electricity supply business by National Power, and of SWALEC’s supply business by British Energy. Scottish Power also acquired Manweb, and Scottish Hydro-Electric merged with Southern Electric to form Scottish and Southern Energy.

In the England and Wales electricity market it is notable that many of the changes led to the evolution of companies that were purely supply focused demerging the distribution aspects into separate network businesses.
Appendix 3 - Brief case studies on Level Playing Field from other utilities markets: Scottish Water

EVOLUTION OF COMPETITION IN WATER

- April 2008: The market for all non-household water and sewerage customers opened

SEPARATION AND COMPLIANCE

The water and sewerage market in Scotland is underpinned by the passage of the Water Services Scotland Act in 1997, the legal framework requiring that Scottish Water be separated and a new legal entity for the competitive retail activities established. The regulatory framework included the establishment of a central market agency, and all parties are bound by a market code which sets out the rules of the market. The market framework is based upon clearly defined roles for the wholesale business (Scottish Water) and Licensed Providers (the retailers, including the incumbent Business Stream).

The regulator, the Water Industry Commission for Scotland (WICS), was keen to ensure full separation of Scottish Water’s activities, and apart from a common parent, the two businesses operate completely at arm’s length.

Some features of the separation and compliance regime in the Scottish water market are:

- Governance Code in Scotland established by WICS with Scottish Water and Business Stream;
- Establishment of a holding company for Business Stream;
- Specific requirements for the protection of information;
- Separate management for the businesses;
- Appointment of a Compliance Officer by Scottish Water;
- Publication of a compliance code;
- Annual compliance statement;
- Physical separation of people, using separate buildings;
- Full IT separation (phased in);
- Cost allocations and separate accounting;
- Voluntary adoption of separate branding;
- Establishment of the Market Code - the market rules; and
- Bilateral Operational Code between Scottish Water and Licensed Providers - setting out services, standards etc.

RECENT DEVELOPMENTS

In recent years Business Stream has made its intentions clear that it will enter the English water market, and has started to undertake some switching.

Discussions over the development of the English water market have included the concept of alignment between the two markets north and south of the border.
If you would like to discuss anything further with us, please contact:

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