

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

**CONTENTS**

1.	INTRODUCTION	2
2.	POWERS AND DUTIES	4
	CONCURRENT POWERS UNDER THE ACT	4
	RELATIONSHIP OF CONCURRENT POWERS WITH DUTIES UNDER THE WATER INDUSTRY ACT 1991	5
	THE FAIR TRADING ACT 1973	6
3.	APPROACH TO INVESTIGATIONS	7
	MARKET DEFINITION	7
	ASSESSMENT OF MARKET POWER	8
	ASSESSMENT OF INDIVIDUAL AGREEMENTS AND CONDUCT	9
	SERVICES OF GENERAL ECONOMIC INTEREST	10
4.	SPECIFIC APPLICATIONS	11
	ISSUES IN PRICING OF WATER AND SEWERAGE SERVICES	11
	COMMON CARRIAGE	14
	COMPETITION IN PROVIDING CONTESTABLE SERVICES	16
	CONDUCT RELATING TO NON-PRICE TERMS	17
	LICENSED ACCESS TO WATER RESOURCES	18
	CONNECTIONS TO WATER MAINS	20
	REQUISITIONS	21
	AGREEMENTS THAT MAY RESTRICT, DISTORT OR PREVENT COMPETITION	22
5.	PROCESS AND PROCEDURES	23
	RESPONSIBILITY FOR CASE HANDLING	23
	COMPLAINTS	23
	NOTIFICATIONS	23
	INTERIM MEASURES DIRECTIONS	24
	APPEALS	24
	THIRD PARTY RIGHTS	24
	COMPLIANCE	24
	ANNEX: LEGAL FRAMEWORK	26
	GLOSSARY	31

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

### **1. INTRODUCTION**

- 1.1 The Competition Act 1998 (**'the Act'**) is applied and enforced by the Director General of Fair Trading and, in relation to regulated utility sectors, concurrently with the regulators for telecommunications, gas, electricity, water and sewerage, and railway services.
- 1.2 The Act introduces two prohibitions:
- a prohibition of agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom (the Chapter I prohibition); and
  - a prohibition of conduct by one or more undertakings which amounts to the abuse of a dominant position, in a market in the United Kingdom (or a part thereof), which may affect trade within the United Kingdom (the Chapter II prohibition).
- 1.3 Further details about the prohibitions are contained in the Competition Act guidelines *The Major Provisions*, *The Chapter I Prohibition*, and *The Chapter II Prohibition*.
- 1.4 The purpose of this guideline is to explain how the Director General of Water Services (**'the Director'**) and the Director General of Fair Trading expect to apply the provisions of the Act to the water and sewerage sectors in England and Wales. It outlines the powers that the Director holds to ensure that competitive processes are unhindered, and provides examples of how these powers may be applied in relation to the water and sewerage sectors. It is designed to increase understanding of the relevance and application of the Act to undertakings, customers, suppliers and new entrants (potential and actual).
- 1.5 The Director's jurisdiction under the Water Industry Act 1991 extends only to England and Wales. Thus the concurrent jurisdiction under the Act, conferred by amendments to the Water Industry Act 1991 inserted under paragraph 5 of Schedule 10 to the Act, has the same geographic extent. Only the Director General of Fair Trading may apply the provisions of the Act in the water and sewerage sectors elsewhere in the United Kingdom. If the Director General of Fair Trading applies the provisions of the Act in the water and sewerage sectors, he will do so in the same manner as the Director, as set out in this guideline.
- 1.6 The Director's concurrent jurisdiction extends to all commercial activities connected with the supply of water or securing of a supply of water or with the provision or securing of sewerage services in England and Wales. The Director's concurrent jurisdiction, therefore, applies to activities within the scope of this definition irrespective of whether they are carried out by water and sewerage companies appointed under the Water Industry Act 1991 (**'undertakers'**) or by other

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

undertakings.

- 1.7 Part 2 of this guideline sets out the powers and duties of the Director with regard to the Act and their relationship with his powers and duties under the Water Industry Act 1991.
- 1.8 Part 3 briefly summarises the approach the Director will adopt in undertaking investigations under the Act.
- 1.9 Part 4 identifies a number of issues particularly relevant to the water and sewerage sectors in England and Wales where the Director may apply his powers under the Act. In particular, the Director's powers under the Act extend to investigating complaints and initiating investigations where he has 'reasonable grounds for suspecting' that either the Chapter I prohibition or the Chapter II prohibition has been infringed.
- 1.10 Part 5 contains details about the processes and procedures that will be important in the application and enforcement of the Act by the Director.
- 1.11 The Annex contains details of the legal framework for economic regulation of the water and sewerage industries in England and Wales and its relationship to the Act.

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

### **2. POWERS AND DUTIES**

#### CONCURRENT POWERS UNDER THE ACT

2.1. Under the Act, the Director has, with two exceptions<sup>1</sup>, all the powers of the Director General of Fair Trading to apply and enforce its provisions with respect to commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services in England and Wales. This means, for example, that the Director's concurrent jurisdiction extends to conduct by undertakings that are not appointed under the Water Industry Act 1991, to the extent that the conduct falls within this definition. In general, the Director will deal with any agreement or conduct that falls within his concurrent jurisdiction. The Director will use the powers to ensure that the competition process is unhindered by anti-competitive activity in the water and sewerage sectors. The Competition Act guidelines *The Major Provisions, Powers of Investigation, Enforcement and Concurrent Application to Regulated Industries* provide further details of the powers contained in the Act. Concurrent powers allow the Director to:

- give guidance on the application of the Act;
- consider complaints about breach of the prohibitions;
- impose interim measures to prevent serious and irreparable damage;
- consider notifications for a decision and give decisions on the application of the Act;
- grant exemptions to the Chapter I prohibition (subject, where appropriate, to conditions);
- carry out investigations both on his own initiative and in response to complaints. The Director has the same powers to require the production of documents and information and to search premises as the Director General of Fair Trading;
- impose financial penalties, taking account of the statutory guidance on penalties issued by the Director General of Fair Trading;
- give and enforce directions to bring an infringement to an end; and
- issue general advice and information on how the Act applies to his sectors.

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<sup>1</sup> The exceptions are that only the Director General of Fair Trading may issue guidance on penalties and make and amend the Director General of Fair Trading's Procedural Rules.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

- 2.2. Section 60 of the Act places an obligation on the Director to ensure consistency with principles established in Community law in the way cases are handled and to ensure that there is no inconsistency with either the principles laid down by the EC Treaty and the European Court or any relevant decision of the European Court. He must also have regard to any relevant decision or statement of the European Commission. The obligation to ensure consistency applies only to the extent that this is possible, 'having regard to any relevant differences between the provisions concerned' (see the Competition Act guideline *The Major Provisions*).
- 2.3. In giving directions to bring an infringement to an end or in giving interim measures directions, the courses available to the Director include:
- requiring an undertaking to terminate an unlawful agreement or to cease unlawful conduct (for example, an unreasonable refusal to grant access or services); or
  - requiring an undertaking to modify conduct or agreements so as to prevent existing (and future) breaches of the prohibitions in the Act.
- 2.4. Directions given and penalties imposed are subject to appeal to the Competition Commission.

RELATIONSHIP OF CONCURRENT POWERS WITH DUTIES UNDER THE WATER INDUSTRY ACT 1991

- 2.5. The Director's general duties under the Water Industry Act 1991 remain unchanged in relation to his regulatory functions in the water and sewerage industries. Instead, the Act amends his duty in relation to competition.
- 2.6. Specifically, the Act<sup>2</sup> amends the Water Industry Act 1991 to provide that the Director should not have regard to his general duties when exercising any function under the Act, except that he may have regard to any matter to which the Director General of Fair Trading could have regard when exercising that function. This means, for example, that when imposing financial penalties under the Act the Director will take account of the statutory guidance issued by the Director General of Fair Trading, and will not have regard to his duty under the Water Industry Act 1991 to secure that undertakers are able to finance the proper carrying out of their functions.
- 2.7. Where a particular agreement or practice falls within the scope of the Water Industry Act 1991 as well as one of the prohibitions in the Act, the Director is able to decide to use his powers under either the Water Industry Act 1991 or the Act. In such cases he will make use of whichever statutory powers he judges to be the more appropriate to address the specific conduct. Where he takes action using his powers under the Act, his duty to take enforcement action under the Water Industry Act 1991 does not apply. The Director will keep concerned parties informed regarding the statutory basis for his approach in handling a case.

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<sup>2</sup> paragraph 5(4) of schedule 10 to the Act.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

- 2.8. The Director may make use of information made available to him for the purposes of sector regulatory duties under the Water Industry Act 1991 in relation to the application of the Act, and vice versa. Information made available to the Director for sector regulatory duties may, for example, be material in providing reasonable grounds for suspecting an infringement prior to the initiation of an investigation under the Act. Where information obtained in performing any of his statutory duties gives rise to such reasonable grounds, the Director will initiate further investigations.
- 2.9. The Director will seek to apply consistent policy principles to related subject matter irrespective of whether a matter is addressed through powers under the Competition Act or through his powers under the Water Industry Act 1991.

THE FAIR TRADING ACT 1973

- 2.10 Some cases may fall within the complex monopoly and scale monopoly provisions in the Fair Trading Act 1973 which are retained in addition to the Competition Act. Further details are contained in the Competition Act guideline *The Major Provisions*. The Director has a separate concurrent jurisdiction with Director General of Fair Trading under the Fair Trading Act. It is not intended that the prohibitions in the Competition Act and the monopoly provisions in the Fair Trading Act should be used in parallel to investigate the same matters.
- 2.11 The complex monopoly provisions are retained for activities which are not caught by the Competition Act prohibitions: where, for example, a group of companies all adopt similar practices or engage in parallel behaviour which appears to be anti-competitive, but there is no evidence of collusion or agreement. The scale monopoly provisions are intended for dealing with the situation where a prior infringement of the prohibitions in the Competition Act has already been proven but where the Director believes that there is a real prospect of further abuse by the same company. The structural remedies available under the scale monopoly powers may be the only effective means of preventing those further abuses.
- 2.12 . Because of the special circumstances of the utility sectors, and the difficulty of establishing competition, the full use of the scale monopoly provisions is retained for the regulated utility sectors. This means that the scale monopoly provisions may be used in the water and sewerage sectors whether or not there has been a prior infringement of the prohibitions in the Competition Act.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

**3. APPROACH TO INVESTIGATIONS**

- 3.1 In determining whether a particular agreement or particular conduct constitutes a breach of either of the Act's prohibitions, the Director (or the Director General of Fair Trading, as appropriate) will generally consider:
- the definition of the market to which the agreement or conduct in question relates (market definition is important because market power can only be analysed in the context of the relevant market);
  - whether the undertaking or undertakings in question have market power, although certain types of agreement may breach the Chapter I prohibition, even where the parties do not have market power (the concept of market power is not part of the statutory framework of the Act but it is a useful tool in assessing potentially anti-competitive behaviour); and
  - whether the individual agreement or conduct is a breach of the Act's prohibitions.
- 3.2 The Competition Act guidelines *Market Definition, Assessment of Market Power and Assessment of Individual Agreements and Conduct* contain detailed guidance on these stages of investigations. The sections below summarise details that are particularly relevant to investigations of possible infringements in the water and sewerage sectors.

MARKET DEFINITION

- 3.3. The prohibitions in the Act are designed primarily to prevent undertakings from exploiting market power. In defining the relevant market the Director will make use of the conceptual framework outlined in the Competition Act guideline *Market Definition*, which emphasises product and geographic definitions of markets. Product and geographic market definitions are derived from consideration of an undertaking's freedom to raise the price of the product or service in question. The definition of the relevant market in cases arising in the water and sewerage sectors may not always be immediately obvious.
- 3.4 When considering the product definition of a market, the Director will analyse the specific nature of the product or service in question: for example a distinction between services for domestic and industrial customers may be appropriate. In some cases, the Director may define markets for products or services that are inputs to, or components of, the provision of water or sewerage services.
- 3.5 While geographical factors are likely to be of critical importance in market definition, the Director will not be bound in all cases by geographical patterns inherited at privatisation. The development of inset appointments, private supplies, on-site services, bulk supplies and common carriage arrangements may be important influences on geographic market definitions, and geographic market definitions will

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

therefore require detailed analysis. In relation to water or sewerage services for domestic customers, for example, the Director may find that the licensed area of a water or sewerage undertaker constitutes the relevant geographic market. However, this same geographic market definition may not apply in the case of water supply or trade effluent disposal for large customers.

- 3.6 High market shares are not themselves prohibited, and do not necessarily indicate a competition problem.

### ASSESSMENT OF MARKET POWER

- 3.7 The assessment of market power can be useful under both the Chapter I prohibition of the Act in considering the concept of ‘appreciability’ (see paragraph 2.18 of the Competition Act guideline *The Chapter I Prohibition*) and under the Chapter II prohibition to assist in the identification of ‘dominance’ (see paragraph 3.9 of the Competition Act guideline *The Chapter II Prohibition*). Thus, having defined the relevant market, the Director will normally assess whether the undertaking or undertakings in question have market power.

- 3.8 An agreement will infringe the Chapter I prohibition only if it has as its object or effect an ‘appreciable’ prevention, restriction or distortion of competition in the United Kingdom. The Director takes the view that an agreement will generally have no appreciable effect on competition if the parties’ combined share of the relevant market does not exceed 25 per cent, although there will be circumstances in which this is not the case. The Director will, in addition, generally regard any agreement between undertakings which:

- directly or indirectly fix prices or share markets;
- imposes minimum resale prices; or
- is one of a network of similar agreements which have a cumulative effect on the market in question

As being capable of having an appreciable effect even where the combined market share falls below the 25 per cent threshold.

- 3.9 In respect of the Chapter II prohibition, the Director will assess whether the undertaking or undertakings in question occupy a dominant position in the relevant market. The European Court has defined a dominant position as:

# Competition Act 1998

## Application in the Water and Sewerage Sectors

(31 January 2000)

‘a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.’

- 3.10 The Act does not set any market share thresholds for defining ‘dominance’, but the European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50 per cent<sup>3</sup>. The Director considers it unlikely that an undertaking will be individually dominant if its market share is below 40 per cent, although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market) provided strong evidence of dominance. Market share on its own does not, however, determine whether an undertaking is dominant.
- 3.11 In assessing whether there is dominance, the Director will consider whether and the extent to which an undertaking faces constraints on its ability to behave independently. Those constraints might be:
- existing competitors, according to their strength in the market. This may be shown by market shares;
  - potential competitors. This may be shown by a lack of significant entry barriers and the existence of other undertakings which might easily enter the market; and
  - other constraints such as strong buyer-power from the undertaking’s customers or the effect of government regulation.
- 3.12 In many circumstances in the water and sewerage sectors, entry barriers will be important factors in the Director’s assessment of dominance. This is discussed in more detail in the Competition Act guideline *Assessment of Market Power*. Entry barriers that may be of particular relevance in the water and sewerage sectors include the existence of large sunk costs in many markets and absolute advantages arising from the regulation of water abstractions and discharges to the environment.

### ASSESSMENT OF INDIVIDUAL AGREEMENTS AND CONDUCT

- 3.13 The analysis of an individual agreement or conduct is a key stage in investigating whether there is a breach of the Chapter I or Chapter II prohibition. The overall approach in this regard is described in the Competition Act guideline *Assessment of Individual Agreements and Conduct*. Part 4 of this guideline contains a number of examples of issues relevant to the water and sewerage sectors where the Director’s powers may be applied. Many of the examples concern possible abuses of a dominant position, but there may also be a breach of the Chapter I prohibition where abusive conduct is the subject of an agreement between undertakings.

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<sup>3</sup> *AKZO Chemie BV v Commission Case* [1993] 5 CMLR 215

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

SERVICES OF GENERAL ECONOMIC INTEREST

- 3.14 The prohibitions do not apply to ‘an undertaking entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly in so far as the prohibition would obstruct the performance, in law or in fact, of the particular tasks assigned to that undertaking’<sup>4</sup>. The Director considers that water and sewerage undertakers may fall within the category of undertakings entrusted with the operation of services of general economic interest, but the exclusion applies only in so far as the prohibition would obstruct the performance of tasks assigned to an undertaking, and does not apply to an undertaking or its activities generally. The Director considers that there are many aspects of undertakers’ conduct where the exclusion is unlikely to apply. A number of these aspects are described further in Section 4. The Competition Act guideline *Services of General Economic Interest* provides further details of the exclusion, and relevant European case law.

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<sup>4</sup> the exclusion contained in paragraph 4 of Schedule 3 to the Act

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

(31 January 2000)

### **4. SPECIFIC APPLICATIONS**

4.1 This part identifies a number of issues specific to the water and sewerage sectors where the Director may apply his powers under the Act to enforce the Chapter I and Chapter II prohibitions. The issues identified here are not exhaustive: some indications are given of how the Director may approach investigations and the application of his powers in relation to the identified issues. The Director will impose financial penalties on infringing undertakings, where appropriate. Further details are contained in the Competition Act guideline *Enforcement*.

#### ISSUES IN PRICING OF WATER AND SEWERAGE SERVICES

4.2 Until now, competition on price terms for water and sewerage services has been relevant mainly to large users, although this form of competition may be extended further in future. The Water Industry Act 1991<sup>5</sup> allows customers who are supplied (or likely to be supplied) with a quantity of water at or above a specified volumetric threshold the opportunity to secure a supply of water or sewerage service from an undertaker other than the one in whose area they are situated<sup>6</sup>. The volumetric threshold is currently 250,000 cubic metres per year. Most undertakers have responded to the threat of losing their large volume customers by introducing lower charges for these customers. In some cases, undertakers have offered lower tariffs as a direct result of competitive action by new entrants.

4.3 The tariff basket mechanism permits undertakers to rebalance tariffs between categories of customers (for example between customers on a meter and those charged by other means, such as rateable values). Undertakers have been able to offer tariffs for their large users without reducing overall revenues, and have therefore been able to compete on price in a manner that could be predatory or exclusionary, without significant risk to their revenue. Tariffs for users whose supply of water is above the large user threshold will be removed from the tariff basket from 1 April 2000. This will prevent undertakers from rebalancing tariffs to recover lost revenues from other groups of customers. Undertakers could, however, still breach the Chapter II prohibition if they set predatory prices or if they set prices at excessively high levels.

#### *Approach to Pricing Conduct*

4.4 The pricing conduct of water and sewerage undertakers is currently subject to detailed regulation under the licence conditions. Condition E of the licence, for example, prohibits undertakers from exercising undue preference or undue discrimination in the charging of customers (and categories of customers). The Director's view is that large user tariffs should normally be set with reference to a robust estimate of the long run marginal costs of supply.

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<sup>5</sup> as amended by the Competition and Services (Utilities) Act 1992.

<sup>6</sup> This opportunity is also open to customers where the area is a greenfield site or where the incumbent undertaker consents to change its boundary. Further details are contained in the Ofwat publication *Inset appointments – Guidance for applicants*.

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

- 4.5 Furthermore, under the Water Industry Act 1999, undertakers' charges schemes are subject to approval by the Director. The exercise of the power to approve charges schemes takes effect from 1 April 2000 and involves the consideration of a number of criteria, including undue preference and undue discrimination.
- 4.6. In addition, the pricing conduct of undertakers (and other undertakings involved in commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services) may infringe the prohibitions in the Act. The Director may use both sets of powers in addressing issues raised by the pricing conduct of undertakings in the water and sewerage sectors. Some aspects of pricing conduct may be effectively dealt with in terms of compliance with the licence conditions, while other types of pricing conduct may be addressed through the use of the Director's powers under the Act.
- 4.7. The Director will consider the detailed circumstances of each case in deciding how to address pricing conduct, and whether or not the conduct involves breach of one of the Act's prohibitions. The relevant market and physical and technical circumstances are subject to change over time, however, and the Director's view of pricing conduct will take account of the prevailing circumstances.
- 4.8 The power to approve charges schemes will be exercised on an annual basis and will involve review of many aspects of the pricing conduct of undertakers, again in the light of prevailing circumstances. Following the coming into force of the Water Industry Act 1999, once the Director has approved a charges scheme he would not normally expect to re-open any of its contents before the undertaker submitted its proposals for the following year. He may, however, in some circumstances, investigate and conclude that the undertaker's conduct warrants further action under the Act.

### *Approach to Cost Assessment*

- 4.9 Costs will be a key consideration in the assessment of pricing conduct in relation to the Act's prohibitions: their assessment will follow the approach outlined in the Competition Act guideline *Assessment of Individual Agreements and Conduct*. Where the Director has grounds to suspect that pricing conduct breaches either of the prohibitions in the Act, he will investigate the costs of providing the product or service in question. He will make use of cost information already available to him and will examine the consistency of approach used by undertakers in cost analyses for the purposes of setting tariffs and special agreements, arrangements for bulk supplies, resource development, leakage control and demand management.
- 4.10 In some cases water and sewerage undertakers may be judged to serve a number of markets, which are subject to varying levels of competition. It may then be necessary for the assessment of costs to involve consideration of undertakers as multi-product companies, with examination of methods of cost allocation to different products or services. An undertaker might, for example, exploit a dominant position in one market to subsidise predatory behaviour in another market.

### *Predation*

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

- 4.11 Section 60 of the Act sets out certain principles with a view to ensuring that the United Kingdom authorities handle cases in such a way as to ensure consistency with Community law (see paragraph 2.2 above). When the Director considers allegations of possible predatory pricing, the judgments of the European Court of Justice referred to in the Competition Act guidelines *The Chapter II Prohibition and Assessment of Individual Agreements and Conduct* may be relevant decisions<sup>7</sup>, in that they relate to a corresponding question arising in Community law. Broad guidelines for the assessment of costs in relation to predatory pricing may be drawn from these judgments. These focus on average variable costs and average total costs.
- 4.12 The European Commission's *Notice on the Application of Competition Rules to Access Agreements in the Telecommunications Sector*<sup>8</sup> states 'in network industries a simple application of the above rule [that is, use of average variable costs and average total costs] would not reflect the economic reality of network industries'. In many circumstances the water and sewerage industries may be regarded as network industries. The Director considers that the network industry characteristics of water and sewerage industries include the high proportion of common costs, the large fixed costs associated with network infrastructure, and the potential importance of access to network facilities for service markets. There may, therefore, be circumstances where the Director might consider that the judgments of the European Court of Justice referred to above do not address corresponding questions in terms of section 60 of the Act because of the specific nature of the water industry as a network industry, and the implications of this for the assessment of costs.
- 4.13 Where appropriate, therefore, the Director will assess the total costs that are incremental to the provision of a service, and will have regard to the relevant time frame over which costs should be analysed. In many circumstances, the Director considers that long run marginal costs will be an appropriate framework for the analysis of costs, due to the typically high proportion of total costs which are accounted for by long-lived capital assets in the provision of water and sewerage services. Prices set at or above long run marginal costs would not normally present concerns in relation to predation.

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<sup>7</sup> Including, for example, Case C62/86 *AKZO Chemie BV v Commission* [1993] 5 CMLR 215, and *Tetra Pak II* [1997] 4 CMLR 662.

<sup>8</sup> European Commission *Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector Framework, relevant markets and principles*, Notice 98/C265/02

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

*Excessive Prices*

- 4.14 Where an undertaking is dominant in a market, it is possible that prices may be set at excessively high levels. Prices may be considered excessively high when the price charged bears no reasonable relation to the economic value of the good or service supplied. In this instance, such behaviour could be an abuse of a dominant market position under the Chapter II prohibition. In cases where there may be excessive pricing, the Director may have regard to measures of the profitability or the ‘stand-alone costs’ of an activity.

*Other Relevant Information*

- 4.15 In addition to cost-based information the Director will consult with Ofwat Customer Service Committees<sup>9</sup> and have regard to other evidence regarding the structure of markets and the effects of pricing conduct on competition. Evidence of intention, for example, may strengthen the case for regarding some instances of pricing conduct as predatory. A dominant undertaking which was unable to justify its pricing policy in commercial terms, and which would benefit only if one or more of its competitors were weakened, would normally be considered to be abusing its position. Similarly, the persistence of supra-normal profits or the introduction of significant price increases in the absence of commensurate cost increases may be regarded as indicators of excessively high prices.

COMMON CARRIAGE

- 4.16 The Director regards ‘common carriage’ as the shared use of assets by undertakings. In many circumstances it would be uneconomic for a competitor to duplicate the provision of large assets, such as a pipe network or treatment facility. Common carriage, therefore, has the potential to increase customer choice by facilitating the entry of competitors (whether existing undertakers or new entrants) into a local market.
- 4.17 There is no specific statutory framework for common carriage, but this does not prevent undertakings from agreeing to such arrangements, including the associated terms and conditions<sup>10</sup>. In general, however, incumbent undertakers may have little incentive to offer access to their facilities to other suppliers. In some cases refusal to allow a competitor to access or share facilities may be objectively justifiable – where, for example, the competitor refused to give adequate assurances on water quality or refused to make a reasonable contribution to necessary reinforcement costs. In other cases the refusal may be without any objective justification. Under the Act, such a refusal by a dominant undertaking to grant access to facilities that would allow another undertaking to compete in a related market may be an abuse of a dominant position. Similarly, the imposition of unreasonable price or non-price terms for access could

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<sup>9</sup> Ofwat Customer Service Committees are charged to represent the interests of customers and potential customers of the appointed water or sewerage undertakers.

<sup>10</sup> Parties to common carriage agreements must, of course, comply with other relevant statutory requirements, including the abstraction licensing regime and other water resource planning measures administered by the Environment Agency, and the requirements of the Drinking Water Inspectorate.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

infringe the Chapter II prohibition.

- 4.18 The Water Industry Act 1991 provides an effective legal framework for the development of common carriage in a manner that safeguards customers' interests. Undertakers' approaches to the development of common carriage should not endanger the ability of the Director or of undertakers to fulfil their respective statutory duties. In this regard there are a number of issues that undertakers should address in any common carriage agreements. These include:
- the protection of water quality standards;
  - establishing liability in the event of supply failures or quality incidents;
  - responsibility for leakage and maintenance; and
  - reasonable terms of access (including price).
- 4.19 None of these issues should, however, be used merely as a means of restricting competition via common carriage. The Director recognises that undertakers currently address many of these issues within their own operations.
- 4.20 The Director will, therefore, use his powers under the Act to deal with abusive conduct by dominant undertakings. This will allow common carriage to develop where there are genuine opportunities for improved services to customers.

*Refusal to Supply and Essential Facilities*

- 4.21 Refusal to supply by a dominant undertaking may, in some circumstances, be an infringement of the Chapter II prohibition. In particular, the doctrine of 'essential facilities' may be material to the application of the Act in cases regarding common carriage. The Competition Act guideline ***Assessment of Individual Agreements and Conduct*** provides more detailed guidance.
- 4.22 A facility can be viewed as essential if access to it is indispensable in order to compete in a market, and duplication is impossible or extremely difficult owing to physical, geographic or legal constraints (or is highly undesirable for reasons of public policy<sup>11</sup>). A facility cannot be deemed to be essential if other facilities compete in the same relevant market. The principle of common carriage may be applied to all providers of water and sewerage services, but the doctrine of essential facilities is most likely to apply where water or sewerage undertakers are the providers, as they control most of the networks in England and Wales. While the definition of an essential facility must be undertaken on a case by case basis, many of the capital assets of water and sewerage undertakers could be regarded as essential facilities.
- 4.23 Where it has been demonstrated that a facility is essential, it would be for the dominant undertaking to show that a refusal to share access can be justified objectively, and that

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<sup>11</sup> see, for example, the judgment of the European Court of Justice in Case C-7/79 *Oscar Bronner v Mediaprint and others*, [1998] and in particular the opinion of AG Jacobs, paragraphs 47, 65 and 66.

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

the refusal is proportionate to the justification. In some circumstances, an unreasonable refusal to expand the capacity of an essential facility to meet the demands placed on facilities by an undertaking requesting common carriage, or to offer reasonable terms for network expansion, may be regarded as an abuse.

- 4.24 Where the Director has reasonable grounds for suspecting that an infringement of the Chapter II prohibition has occurred, he will ask the owner of the facility to justify his offer of terms for network access or expansion. He may also require the owner of the facility and the person seeking access to provide expert assessments of the matters relevant to the case. This may include supported opinions on the effects on competition of any refusal to grant access, the basis of any objective justification for refusing to grant access and an assessment of what would be reasonable terms to achieve access. If the parties involved cannot agree terms, the Director may find that there has been a breach of the prohibition, and use his powers under the Act to apply a remedy. Where the Director decides that an infringement has occurred he will publish his reasoning and may include analysis of the relevant network costs.

### COMPETITION IN PROVIDING CONTESTABLE SERVICES

- 4.25 Many of the functions currently carried out by undertakers (for example, engineering design, project management, billing, meter reading and call service operation) could be carried out by specialised sub-contractors through out-sourcing arrangements. These functions can be said to be 'contestable'. Out-sourcing may be more efficient than carrying out the function within the undertaker.
- 4.26 Many undertakers make use of out-sourcing arrangements for a number of services, but giving preference to associated companies, or choosing suppliers on subjective grounds, may restrict or distort competition. In the past, the Director has received a number of complaints about tendering procedures used by undertakers, including allegations of special preference given to associated companies. The issue of transfer pricing is already receiving scrutiny by the Director and some aspects of out-sourcing conduct involving preference to associated companies may be more appropriately addressed through licence enforcement action. Some types of conduct may nevertheless still be considered under the Act.
- 4.27 Some undertakers may prefer to continue to provide contestable services themselves. However, the Chapter II prohibition might be breached if, for example, undertakers are manifestly not in a position to satisfy the demand prevailing on a market to the detriment of customers and they prevent third parties from meeting this demand. There might also be a breach of the Chapter II prohibition if undertakers refuse to use modern technology (such as, for example, technology used by third parties who would be prepared to do the work) in providing contestable services and this results in increased costs and/or delays in doing the work.
- 4.28 In addition, an undertaking may be found to be a dominant buyer in a market, and conduct by a dominant buyer directly or indirectly to impose unfair purchase prices or other unfair trading conditions may breach the Chapter II prohibition.
- 4.29 If he finds that an infringement has occurred, the Director will use his powers under

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

the Act to apply a remedy, by, for example, giving directions requiring undertakings to modify conduct in relation to the procurement of contestable services.

CONDUCT RELATING TO NON-PRICE TERMS

- 4.30 Service agreements and contracts between undertakers and their customers contain a variety of non-price terms and conditions, including terms of payment, length of contract, the structuring of charges, and requirements to purchase linked services.
- 4.31 There may be circumstances where undertakings attach non-price terms to contracts or service agreements in a manner that infringes one of the prohibitions in the Act. This can be either by forcing customers to accept terms that restrict their ability to seek competitive offers, or by offering short-run benefits to customers which, in the long run, restrict the development of competition by predation or foreclosure of market entry. Similarly, non-price terms may be exploitative, in that a dominant undertaking may offer an unacceptably low quality of service, or unreasonable non-price terms.
- 4.32 In judging whether non-price terms infringe the prohibitions, the Director will take into account the specific conditions of the market in question, any technical or economic justification for the conduct, and evidence concerning the intent of the undertaking. In the case of long-term contracts, for example, the Director may have regard to the level of investment associated with the provision of a service, and any other objective justification for the terms. The undertaking will be asked to explain the reason for requesting or offering the non-price conditions. Evidence of an intention to behave anti-competitively, however, is not required for conduct to constitute an abuse.
- 4.33 The Competition Act guideline *Assessment of Individual Agreements and Conduct* provides more detailed guidance on these issues. The following paragraphs indicate some examples of possible non-price conduct by water and sewerage service providers that could breach the prohibitions in the Act.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

*Examples*

- 4.34 Tariffs may be offered to customers on the condition that the customer agrees to a long-term commitment, without recourse to competitive suppliers. This may constitute an attempt to foreclose the market, and therefore an abuse of a dominant position under the Chapter II prohibition.
- 4.35 Preferential tariffs or non-price terms such as extended credit facilities may be offered, on the condition that the customer does not seek competitive supplies. This would make it more difficult for competitors to enter the market. Preferential terms offered on long-term contracts are likely to be of concern where it is judged that they do not reflect underlying real cost differences.
- 4.36 Non-price terms may also be used in an anti-competitive manner to discriminate between customers who share similar supply characteristics. Preferential levels of service or the provision of ‘free’ services, for example, could be offered to customers, in place of price reductions, when responding to competitive threats. The effect on competition of this conduct may be the same as predatory price reductions. A related form of conduct would be the offering of preferential terms by undertakings falling under linked ownership arrangements, conditional on loyalty to, or acceptance of, a particular supplier of services. These practices may constitute an infringement of the Chapter II prohibition.
- 4.37 An undertaking may provide a service subject to acceptance of other obligations, tying the supply of one product or service to the supply of others. This approach could be used by undertakings that are dominant in the supply of one service or product to prevent the emergence of competition in the supply of a separate product or service.

LICENSED ACCESS TO WATER RESOURCES

*The Abstraction Licensing Regime*

- 4.38 Access to, and the use of, water resources is currently governed by a licensing regime operated by the Environment Agency, the Secretary of State for the Environment, Transport and the Regions, and the Welsh Assembly. Those who wish to abstract and use water from rivers or the ground must be licensed by the Environment Agency. This confers protected rights on the licensee, preventing the grant of further licences in derogation of the earlier right without that licence holder’s consent. Under current rules, licensed entitlements are not directly tradable, although the Environment Agency and the Secretary of State may revoke or modify a licence. If that happens, or if the Environment Agency grants a new abstraction licence in derogation of protected rights and without the abstraction licensee’s consent, the Environment Agency is liable to pay compensation<sup>12</sup>.

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<sup>12</sup> The Environment Agency is not permitted to grant new abstraction licences that are known to be in derogation of existing protected rights. Compensation must be provided if the grant of a new licence is later shown to be in derogation of protected rights.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

4.39 The Government has announced the changes it intends to make to this regime<sup>13</sup>. Some will be made within existing legislation (the Water Resources Act 1991), but others will require new legislation which the Government will bring forward when Parliamentary time allows. The Environment Agency will draw up Abstraction Management Strategies on a catchment basis. New licences will be time-limited, generally to around 15 years, although longer periods will be appropriate in certain circumstances at the discretion of the Agency. Most existing licences will gradually be converted to time-limited status on a prioritised basis. There will be a general presumption of renewal of any time-limited licence, and the Agency will be expected to do this in accordance with its Abstraction Management Strategies and will take account of needs for emergency reserves. The Agency will be empowered to compel one water undertaker to seek a bulk supply from another or the transfer of licences where that is necessary to secure proper use of water resources.

*Application of Competition Rules*

4.40 The Director considers that an abstraction licensee's conduct in exploiting (or seeking to protect) its licensed entitlements could be a breach of the Chapter II prohibition. The fact that an abstraction licensee is entitled under the abstraction licence to use a resource in a particular way does not remove its actions from consideration under the Act.

4.41 There may be circumstances in which an abstraction licensee's reliance on protected rights could have an anti-competitive effect. For example, it may be using only a proportion of the licensed entitlement but rely on its protected rights to resist an application from a third party to abstract from a neighbouring borehole in derogation of the abstraction licensee's unused entitlement. Such conduct could be regarded as an abuse if it would be likely to eliminate all competition in a related market.

4.42 Reliance on protected rights to abstract from a river to defeat an application from a potential upstream abstractor may also constitute an abuse. In particular, this may constitute a breach of the Chapter II prohibition where the conduct meant that customers could deal only with the downstream abstraction licensee.

4.43 In some circumstances a resource could be an 'essential facility', and unreasonable denial of access, or a refusal to supply, may amount to an abuse. Even if a resource were not regarded as an essential facility, the question as to whether an incumbent abstraction licensee's conduct was a breach of the Chapter II prohibition could still arise, depending on the particular circumstances of the case. Where the Director decides that an abstraction licensee's reliance upon protected rights or refusal to supply constitutes an abuse of a dominant position, he will consult with the Environment Agency in order to determine the most effective means of bringing the infringement to an end, having regard both to his powers under the Act and to relevant provisions governing the use and allocation of water resources.

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<sup>13</sup> *Taking Water Responsibly: Government decisions following consultation on changes to the water abstraction licensing system in England and Wales*, Department of Environment, Transport and the Regions/Welsh Office, March 1999.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

CONNECTIONS TO WATER MAINS

- 4.44 Water undertakers have a duty under Section 45 of the Water Industry Act 1991 to make connections to the water mains to enable provision of water supplies for domestic purposes. They are entitled to recover expenses reasonably incurred in carrying out such work<sup>14</sup>. Some undertakers allow contractors to do some of the preparatory work.
- 4.45 As a result of complaints to the Director about the level of expenses requested by the undertakers for doing this work, he has found that some undertakers have overcharged the customers. Such behaviour may constitute an abuse of a dominant position especially when there is little or no competitive alternative.
- 4.46 The reasonableness of costs incurred for connections to water mains is likely to remain an issue where water undertakers continue to insist on making the connections themselves. The application of connection charges that are, for example, not cost-reflective might be found to be in breach of the Chapter II prohibition. In assessing the reasonableness of costs the Director may have regard to evidence about the level of costs that would have been incurred if the undertaker had followed a competitive tendering process. When assessing whether an undertaker has abused its dominant position, the Director will have regard to the fact that some undertakers allow customers to make arrangements for some of the preparatory work, while some do all the work themselves.
- 4.47 The Director will continue to use his powers of determination under the Water Industry Act 1991<sup>15</sup> to consider individual complaints about the cost of specific connections made by the undertakers. In addition, he may use his powers under the Act to judge whether an undertaker may have abused its dominant position by consistently overcharging customers.
- 4.48 If the Director has reasonable grounds for suspecting that an infringement of the Chapter II prohibition has occurred, undertakers will be required to provide information concerning their policies and requirements on the use of contractors, the costs of making the connection, and the process for deriving costs and charges. If the Director finds that an undertaker has abused its dominant position, he will use his powers under the Act to apply a remedy.

REQUISITIONS

- 4.49 The Water Industry Act 1991 requires undertakers to install public mains and sewers within set timescales when requisitioned by the owner or occupier of premises or by

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<sup>14</sup> Sections 106 and 107 of the Water Industry Act 1991 contain similar provisions relating to connections to public sewers, such that if undertakers insist on carrying out connection work they are entitled to recover expenses reasonably incurred.

<sup>15</sup> Water Industry Act 1991 Section 45 (6A), as amended by the Competition and Services (Utilities) Act 1992. Under section 107 (4A) of the Water Industry Act 1991 the Director also has powers of determination in relation to disputes about the cost of connections to public sewers. The Director is still able to apply his powers under the Act to such abusive conduct.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

the local authority. Similarly, developers who want to develop land can require undertakers to move mains or sewers. The undertaker is entitled to recover its expenses reasonably incurred for installing or diverting the infrastructure. The Water Industry Act 1991 also provides that disputes about costs incurred in installing mains or sewers may be resolved by arbitration. Although the Director has no role in that process, complaints have still been received by the Director about the level of costs imposed by undertakers (mainly where the undertaker has offered to receive a one-off payment instead of recovering the cost over 12 years, as provided for under the Water Industry Act 1991). Other areas of concern include the length of time taken to carry out the work, excessive levels of overheads charged, and delays in responding to requests for requisitions.

- 4.50 Developers often find it efficient and economic to provide their own on-site services. Some undertakers will agree to adopt systems that the developer has laid, but, in the case of water facilities, there is no procedure under which a developer may appeal to the Director if a water undertaker refuses to conclude such an agreement. An undertaker's refusal to enter into such an arrangement could be an abuse of a dominant position, in that the undertaker's insistence on doing the work at the developer's cost would foreclose the market for such works. In assessing whether such conduct breaches the Chapter II prohibition, the Director will consider any justification offered by the undertaker, but will also take into account the ability of other undertakers to co-operate effectively with developers in comparable circumstances. Any agreement between undertakers, either explicit or implicit, not to co-operate with developers may be an infringement of the Chapter I prohibition.
- 4.51 The Director considers that excessively high prices, unjustified delays or unreasonable terms imposed by undertakers for requisitions or infrastructure diversions may constitute an abuse of a dominant position under the Chapter II prohibition. The key test will be that expenses incurred by undertakers should be 'reasonable'. In making that judgement, the Director will have regard to the relationship between the amounts charged by undertakers and the costs of carrying out the work. He will also consider whether the works paid for were reasonably required for the requisition in question.
- 4.52 The Director will use his powers under the Act to remedy abuses in relation to requisitions or infrastructure diversions. A direction could, for example, require an undertaker to allow developers to engage their own contractors for water installations or infrastructure diversions (subject to appropriate verification of standards, at reasonable cost, by undertakers), or that charges for a particular requisition or infrastructure diversion be modified.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

EXAMPLES OF AGREEMENTS THAT MAY RESTRICT, DISTORT OR PREVENT COMPETITION

4.53 Competition in water and sewerage service provision may be prevented, restricted or distorted by formal or informal agreements among undertakings, to the detriment of customers or those who trade with them, in breach of the Chapter I prohibition.

Examples of such agreements include those:

- between undertakers not to compete in each other's areas of appointment, for example in relation to cross-border supplies, common carriage or inset appointments;
- between undertakings to collude on pricing conduct;
- leading to collusion in bidding for contracts (including agreements not to bid);
- leading to preference for related, or each other's related, suppliers in procurement or the out-sourcing of contestable services;
- leading to collusion with the intention of preventing, restricting or distorting comparative competition<sup>16</sup>; and
- leading to the restriction of access by third parties to essential facilities.

4.54 The Director will use his powers under the Act to investigate suspected cases of anti-competitive agreements or concerted practices, and apply remedies where an agreement breaches the Chapter I prohibition. Further guidance on the Chapter I prohibition and on the criteria for exemption is given in the Competition Act guideline *The Chapter I Prohibition*.

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<sup>16</sup> the broad approach to regulation used to deliver improvements in prices and services for customers, whereby price limits and service standards are set with reference to comparisons based on the past performance of companies.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

**5. PROCESS AND PROCEDURES**

- 5.1 This part provides a brief indication of the elements of process and procedures that the Director will follow in enforcing the Act under his concurrent powers. Further details are contained in the Competition Act guidelines *Concurrent Application to Regulated Industries* and *The Major Provisions*.

RESPONSIBILITY FOR CASE-HANDLING

- 5.2 In general, any agreement or conduct which relates to commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services in England and Wales will be dealt with by the Director. This may include conduct in specific markets for inputs or services that are components of the wider provision of water or sewerage services.
- 5.3 The Director and the Director General of Fair Trading will always consult each other where it appears that there is a possibility of concurrent jurisdiction before either acts in a case, and will avoid a matter being addressed by both. They will consult each other during the course of an investigation as appropriate, regardless of which is responsible for handling a case.

COMPLAINTS

- 5.4 Complaints may be made to the Director or to the Director General of Fair Trading, but **should not be made to both** (although complaints about licence conditions *only* should continue to be sent direct to the Director). Guidance on the information that should be included in a complaint can be obtained from the Office of Fair Trading or any regulator.
- 5.5 Where the complaint concerns subject matter that may involve breach of both the prohibitions in the Act and sector-specific licence conditions, it will normally be considered by the Director.

NOTIFICATIONS

- 5.6 Parties to an agreement or conduct may notify the Director General of Fair Trading for guidance or a decision for clearance or (in the case of the Chapter I prohibition) for exemption decision. A standard form (Form N) must be used for notifications. A copy should also be sent to the Director where the case falls under his concurrent jurisdiction.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
**(31 January 2000)**

INTERIM MEASURES DIRECTIONS

- 5.7 The Director has the power to impose interim measures directions during an investigation when he has a reasonable suspicion that one of the prohibitions has been infringed and he considers that it is necessary for him to act as a matter of urgency, to prevent serious, irreparable damage to a person or category of persons, or to protect the public interest. He may give such directions as he considers appropriate, which may include modification or termination of an agreement or conduct (see the Competition Act guideline *The Major Provisions*).

APPEALS

- 5.8 Any party to an agreement in respect of which the Director has made a decision, and any person in respect of whose conduct the Director has made a decision, may appeal to the Competition Commission. Appeals against decisions made under the Act are possible both on the substance of the decision and on any penalties imposed. Any appeal made to the Competition Commission against a decision of the Director will be determined by an appeal tribunal.

THIRD PARTY RIGHTS

- 5.9 The Act provides for a third party who has 'sufficient interest' in the decision to appeal against a decision made by the Director. Further details are contained in the Competition Act guideline *The Major Provisions*.
- 5.10 Third parties who consider that they have suffered loss as a result of any unlawful agreement or conduct may claim for damages in the courts.

COMPLIANCE

- 5.11 The Director General of Fair Trading has recommended that programmes for compliance with the Act should form an integral part of businesses' preparation for the new regime. This guideline outlines how the introduction of the new prohibitions under the Act will have significant implications for undertakings involved in the water and sewerage industries. In some cases, it is possible that aspects of current conduct may require modification to ensure that the prohibitions are not infringed.
- 5.12 The Director expects that water and sewerage undertakings will find it prudent to implement a corporate compliance programme to minimise the risk of infringements. In order to be effective, compliance programmes will require the introduction of appropriate compliance procedures, thorough initial and on-going training programmes for all relevant staff, and continuous evaluation and feedback supported by personal commitment from senior management.

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

- 5.13 As outlined in the Competition Act guideline *Enforcement* and the Director General of Fair Trading's *Guidance on Penalties*, the degree to which undertakings can demonstrate a genuine commitment to compliance with the provisions of the Act will be an important factor in determining the severity of any penalties imposed. Part 4 of this guideline highlights a number of specific issues that, together with the general guidance contained in the full series of Competition Act guidelines should be taken into account by undertakings in considering compliance. Further details on compliance are contained in the Office of Fair Trading booklet *How Your Business Can Achieve Compliance*.

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

(31 January 2000)

### **Annex**

#### **Legal Framework for Economic Regulation of the Water and Sewerage Industries in England and Wales and its Relationship to the Competition Act 1998**

##### **Structure of the Water and Sewerage Industry**

In 1989 the ten water authorities in England and Wales were privatised and licences were granted to operate geographical monopolies for all aspects of water and sewerage services. The effect of privatisation was that these authorities became statutory water and sewerage **undertakers**. The water only companies, that were already operating under statute, also became undertakers and subject to the regulatory regime set out in the Water Act 1989.

Every area of England and Wales is allocated one water undertaker and one sewerage undertaker. However, undertakers are not statutory monopolies, in that some customers receive their water and sewerage services from private suppliers who did not become part of the regulatory regime at privatisation. These private suppliers were, and still are, able to supply water and sewerage services as long as they have the resources and assets to do so. They serve a range of customers, from single premises to towns. They are not appointed under the Water Industry Act 1991 and are not regulated by the Director. It is possible for people to develop their own supply and service. Private and individual suppliers and services are regulated, however, by local authorities. They monitor quality standards to the same regulations as licensed undertakers are monitored by the Drinking Water Inspectorate. The Environment Agency regulates water abstractions and discharges of wastewater.

##### **The Director's Duties**

Among other requirements, Section 2 of the Water Industry Act 1991 requires the Director to carry out his principal functions in the manner which he considers best calculated to:

- secure that the functions of a water undertaker and a sewerage undertaker are properly carried out for every part of England and Wales and to secure that undertakers are able to finance the proper carrying out of their functions. This gives rise to the need for the Director to ensure that he is satisfied that inset applicants have managerial competence and financial viability to carry out their functions as an undertaker;
- protect the interests of every person who is a customer or potential customer of a company which has been or may be appointed to be an undertaker. This applies principally to the charges applied by the undertaker and to the quality of its service;
- promote economy and efficiency on the part of any undertaker in the carrying out of its functions;
- facilitate effective competition, both between undertakers and those seeking to become

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

undertakers.

These requirements will not apply to the exercise by the Director of his concurrent powers under the Act (see paragraphs 2.5 to 2.9 above).

### **Principal Features of the Regulatory Regime**

There are 10 water and sewerage companies and 17 water companies (undertakers). The conditions of their Appointments are generally similar, although a few have been modified to reflect an undertaker's membership of a larger group of companies, especially if that group contains another licensed utility, such as a Public Electricity Supplier.

The standard conditions provide the detailed means whereby the Director regulates the undertaker's activities, especially their financial and operational performance and their conduct towards customers. There is provision for the setting and revision of price limits (which from 1 April 2000 will take place automatically every five years) as well as for checking that year-on-year price increases comply with each undertaker's limit.

At the same time, the licence prohibits undertakers from levying charges that are unduly preferential or discriminatory, as between classes of customers (or, in the case of individual agreements, between the customers covered by them).

Paragraph 4.4 of this guideline describes the Director's approach to validation of charges by reference to long run marginal cost. Whenever the issue arises the undertaker should be able to show that particular charges are broadly related to the appropriate measure of cost. Failing that, the Director will consider whether the charges are unduly preferential or discriminatory and, at the same time, whether they (or any associated terms) may breach the Chapter II prohibition of abuse of a dominant position.

### **The Water Industry Act 1999**

Under the Water Industry Act 1999, undertakers are required to obtain the Director's approval of their charges schemes, under which they customarily raise much of their revenue. This takes effect from 1 April 2000.

In deciding whether to approve a charges scheme, the Director will have regard to any Ministerial guidance received about the social and environmental objectives, which the charges schemes ought to reflect. At the same time, each undertaker is required to include in its charges scheme items which have been specified in regulations (made by statutory instrument). These will deal particularly with the protection of the interests of disadvantaged customers, such as larger families on low incomes and persons whose illness or disability dictates larger-than-normal consumption of water (for example, those using kidney dialysis machines).

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

The Director's function in approving charges schemes will not be limited to the matters just described and he will examine each scheme, to satisfy himself that there is no evidence of inappropriate charges. As noted above, this may include charges which are not reflective of costs, or which appear to have an anti-competitive effect, for example if a tariff were made available only to selected customers where the undertaker anticipated the threat of competition.

Once the Director has approved a charges scheme, he would not normally expect to re-open any of its contents before the undertaker submitted its proposals for the following year. However, in some circumstances he may investigate and conclude that the undertaker's conduct warrants further action under the Act.

### **Enforcement**

The Director is required to take action against any breach of an undertaker's licence obligations, unless he is satisfied that it is trivial or an undertaker has given an undertaking not to repeat it; or that some aspect of his other duties precludes him from taking that action. In addition, he will be relieved of that obligation if he concludes that it would be more appropriate to take action under the Act.

### **Competition**

There is provision for competitive entry into the water and sewerage industries in England and Wales. The Director is authorised to appoint new undertakers in either (or both) capacities. This might happen with the agreement of the incumbent undertaker or, failing that, when the new appointment covers an undeveloped ('greenfield') site or the customer concerned uses, or is expected to use, at least 250,000 cubic metres per year. In making such an appointment, the Director is empowered to require an incumbent undertaker to provide a bulk transfer of water to the new undertaker or to permit it to connect its sewerage system to the incumbent's system, including the use of its treatment works. Further guidance may be found in *Inset Appointments - Guidance for applicants* published by Ofwat in February 1999.

The Director has proposed to the Secretary of State that the large user threshold of 250,000 cubic metres per year should be reduced to 100,000 cubic metres per year, so that the prospect of competition might be available to more large water users.

Since these competitive opportunities were introduced in 1992, many undertakers have revised large user tariffs, no doubt in anticipation of the threat of competition. The Director tests these proposals to see whether there is any evidence of unduly preferential or discriminatory charges (bearing in mind the importance of the broad relationship between charges and the relevant measure of cost). He will also consider whether there is any evidence of a breach of the Chapter II prohibition; but he does not believe that the adjustment of tariffs in response to

## **Competition Act 1998**

### **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

a competitive threat must be improper in either case, provided that it can be justified against the appropriate measure of cost and the undertaker applies the charge, or makes it available, to all customers sharing similar supply characteristics.

#### **Other dispute resolution powers**

Apart from the charges which undertakers make to their customers for the provision of water and sewerage services, they have separate entitlements to recover various types of expenses. For example, if a domestic customer asks the undertaker to connect the customer's service pipe to the undertaker's water main, it is entitled to recover the expenses which it reasonably incurs in doing so. Any dispute will be settled by the Director.

Developers, owners of property and local authorities may require the provision of new mains and public sewers to serve their developments. The 'relevant deficit' formula entitles undertakers to recover their costs over 12 years, after giving credit for the water and sewerage charges which accrue from the new development. Any disputes must be referred to arbitration, in which the Director has no role.

The Director may, however, assess the conduct of an undertaker to see whether there is any evidence of an infringement of the Act. He considers that undertakers should allow developers (under appropriate supervision) to make connections between new service pipes and the undertaker's water main (for connections to public sewers, the developer may do that, unless the undertaker opts into the process). On requisitioning, he will examine an undertaker's conduct, especially if it has departed from the relevant deficit by requiring payment of capital sums which are not obviously commutations of the relevant deficit. He will also be alert to complaints about undertakers that will not properly justify the capital charges they are seeking to recover. The underlying issue may be an abuse of a dominant position, bearing in mind that a requisitioner's interests may not be served by potentially lengthy and uncertain arbitration. The Director does not therefore believe that the existence of an arbitration mechanism prevents him from scrutinising such conduct under the Act.

#### **The Director's concurrent jurisdiction with the Director General of Fair Trading under the Fair Trading Act 1973**

The Director has the same jurisdiction as the Director General of Fair Trading to investigate and refer to the Competition Commission cases regarding the existence of scale or complex monopolies. These may arise when either one undertaking, or several, supplies or acquires at least one quarter of the market for goods or services in the relevant part of the United Kingdom. The issue will be whether the existence of the monopoly operates (or may be expected to operate) against the public interest.

The Director has concurrent powers to require information for the purpose of assisting him in determining whether to make a monopoly reference. He may also propose that the Secretary

**Competition Act 1998**  
**Application in the Water and Sewerage Sectors**  
(31 January 2000)

of State accept undertakings in lieu of the Director making a monopoly reference. Part 13 of the Competition Act guideline *The Major Provisions* notes the interface with the Competition Act and some of the circumstances in which resort to this jurisdiction might be appropriate.

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

(31 January 2000)

### **GLOSSARY**

**Terms used in a definition which are themselves defined are italicised.**

**Abstraction licence:** a licence issued by the Environment Agency granting a party the right to abstract water from the environment.

**Appointee:** the company which carries out the business of providing *water* or *sewerage services*, acting under a licence granted under the Water Industry Act 1991.

**Associated company:** a company which is part of the same group of companies as the licensed *undertaker*.

**Average costs:** an undertaking's total costs divided by its output.

**Bulk supply agreement:** an agreement between two *undertakers* for a supply of water from one to the other.

**Capital asset:** the infrastructure vested in a company on which it can earn a return.

**Charges scheme:** it is a condition of an undertaker's licence that it must publish a scheme detailing the charges it will make for providing its services.

**Common carriage:** shared use of assets by undertakings for provision of *water* or *sewerage services*.

**Common costs:** costs which are incurred when supplying a group of products or services, and which would not be reduced if the undertaking ceased supplying one of the products.

**Concurrency:** the application of the Competition Act by the Director General of Fair Trading and the sector regulators.

**Concurrency Working Party:** a forum consisting of representatives of the sector regulators and the Director General of Fair Trading, set up with a view to ensuring the consistent application of the Act.

**Conduct:** the actions of a party in the carrying out of its business.

**Connection charge:** a charge payable to an *undertaker* to cover the direct cost of works and materials required to connect a premises to its main or sewer.

**Contestable:** products, services or markets which are open to competition.

**Cross-border supply:** where an undertaker makes available a supply of water for domestic

# **Competition Act 1998**

## **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

purposes to a customer outside the undertaker's area of appointment. NB this is a water industry term and does not refer to international borders.

**Demand management:** the use of strategies to control the demand for water by customers. Such strategies include selective metering, water efficiency, and leakage control.

**Distribution network:** the pipe system by which water is delivered to customers, including service reservoirs and pumping apparatus.

**Environment Agency:** the non-departmental public body established by the Environment Act 1995. As part of its water resources function, it is responsible for the *abstraction licensing* regime.

**Essential Facility:** a facility access to which is indispensable in order to compete in the market and duplication is impossible or extremely difficult owing to physical, geographic or legal constraints (or is highly undesirable for reasons of public policy).

**Inset appointee:** an *undertaker* that replaces another as a supplier of water and/or sewerage services for one or more customers within a specified geographical area.

**Licence conditions:** conditions contained in the licence by which an *undertaker* operates, which the Director is required to enforce.

**Linked Ownership Arrangement:** where one *undertaker* has an interest in another undertaker either directly or indirectly through another company.

**Long run marginal cost (LRMC):** the costs imposed on a water or sewerage company in supplying or treating an additional increment of water. Long run marginal costs comprise operating and capital costs.

**New entrant:** a new provider of services to customers, which was not an existing *undertaker*.

**Non-price terms:** terms in an agreement which relate to matters other than price, such as the duration of agreement, level of service or provisions relating to liability.

**Out-sourcing:** where provision of goods or services is contracted out to a third party.

**Predation:** strategic behaviour where an undertaking deliberately incurs short term losses in order to eliminate a competitor so as to be able to charge excessive prices in the future.

**Protected Rights:** rights conferred by an *abstraction licence* by which the licensee is entitled to abstract water up to the limit of its *abstraction licence* without let or hindrance.

**Requisition:** a request by one or more customers for an *undertaker* to provide a main for the

## **Competition Act 1998**

### **Application in the Water and Sewerage Sectors**

**(31 January 2000)**

provision of water for domestic purposes or a public sewer for drainage for domestic purposes.

**Sewerage services:** the collection, treatment and disposal of wastewater.

**Special agreement:** an *undertaker* may charge a customer by agreement rather than in accordance with a charges scheme. The agreement can cover price and/or non-price terms.

**Stand-alone costs:** the lowest cost which could be faced by a hypothetical supplier of only a particular product or service. Stand-alone costs include **all** common costs (that is those incurred when supplying a group of products or services, and which would not be reduced if the undertaking ceased supplying one of the products).

**Tendering process:** the bidding process in which a company submits a tender for a contract which is offered by another company.

**Undertaker:** a company appointed to provide *water* and/or *sewerage services* to a defined geographical area. The term is used in the Water Industry Act 1991.

**Undertaking:** any natural or legal person capable of carrying on commercial or economic activities relating to goods or services, irrespective of its legal status. Undertakers fall within this general definition.

**Water Industry Act 1999:** an Act which received Royal Assent on 30 June 1999, to make, *inter alia*, further provision in relation to England and Wales as to charges in respect of the supply of *water* and provision of *sewerage services*.

**Water quality:** properties of water defined by reference to specific criteria specified by the Secretary of State for the Environment, Transport and the Regions. Water Quality is regulated by the Drinking Water Inspectorate in respect of *undertakers*, and by local authorities for private suppliers.

**Water services:** the collection, treatment and distribution of water for domestic and non-domestic purposes.