



THE CURRENT STATE OF MARKET COMPETITION

JULY 2000

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1 Purpose

This paper explains the current state of market competition in the water and sewerage industry in England and Wales. It also sets out some of the developments since the introduction of the Competition Act 1998 (CA98) and the progress we expect as a result of changes in industry perceptions about market competition.

The structure of the paper is as follows:

- Section 2 sets out the Director's approach to competition in the industry.
- Section 3 outlines the current opportunities for market competition and issues that affect it.
- Section 4 explains the competitive developments that have occurred in the industry to date.
- Section 5 discusses the changes in attitude and perception that have occurred over the past two years.
- Section 6 summarises what we see as the immediate future for developments in competition and the challenges and opportunities this provides for Ofwat, the companies and the customers.
- The Annex lists further reading on market competition in the water industry.

2 The Director General's approach

Comparative competition has been successful at encouraging efficiency in the water companies. Market competition is encouraging greater efficiency.

The Director's approach is not to promote market competition for its own sake, or set deadlines for achieving specific results. Instead, he looks to create a framework for competition to develop where it benefits customers. He seeks to create and maintain a level playing field that neither favours entrants nor handicaps incumbents.

CA98 came into effect on 1 March 2000. It prohibits companies from entering into agreements that are anti-competitive and prohibits abuse of a dominant position. It strengthens the Director's powers to investigate complaints and to take action, including imposing financial penalties, where behaviour is anti-competitive. The Act is enforced concurrently with the Director General of Fair Trading, although it is anticipated that the Director will normally deal with cases in the water and sewerage industry in England and Wales. Decisions under CA98 are subject to appeal to the Competition Commission.

Where companies are engaging in potentially anti-competitive behaviour, such as predatory pricing or overcharging on their monopoly activities, the Director will use his powers under competition law to investigate and apply remedies. Similarly, he will seek to reduce barriers to entry, by identifying and investigating areas where companies may be in breach of CA98. Companies that act anti-competitively may be fined. In February 2000 the Director published (jointly with OFT) guidelines on how he will apply these powers under CA98.

3 Current opportunities and issues

A necessary condition for market competition is a choice of supplier for water or wastewater services. Customers can currently choose between regulated and non-regulated suppliers. They can also use their own on-site water resources or waste treatment plant, either instead of, or in conjunction with, public supplies. This continues to be an effective form of competition, particularly with respect to pre-treatment of effluent where customers can reduce the volume and strength of trade effluent to make it cheaper to treat. This section outlines the opportunities that are available or are anticipated to become available as market competition develops.

3.1 *Inset appointments*

Inset appointments allow customers to choose an alternative regulated supplier. They allow one company to replace another as the statutory undertaker for a specified geographical area. Details of the inset appointment mechanism can be found in the Ofwat publication *Inset Appointments – guidance for applicants*, published in February 1999.

The easiest way to gain an inset is if the incumbent consents to change its boundary, giving some of its area to the applicant. This happens rarely, because the incumbent has no incentive to give away its area unless it gets something in return. With the right incentives, however, this could become a relatively straightforward method by which more competitors are created.

If incumbent consent is not given, one of two other criteria must be met before an inset can be granted. An inset can be granted for a site that has no connections to the public supply. In this instance, known as a greenfield inset, there is no volume threshold to meet. Alternatively, if there is an existing supply within the proposed inset area, then the customer can consent to a change of supplier if he consumes at least 250 mega litres per year (MI/y). This is known as a large user inset, and there are around 500 eligible large users. Ofwat was, however, pleased to note that the Government has accepted the Director's recommendation to lower the large user inset threshold to 100MI/y which will allow an additional 1500 large users to apply for an inset appointment. We understand that the Government will make this change to legislation shortly.

The Director will continue to administer efficiently and effectively the process for granting inset appointments. Ofwat will work with potential applicants to provide guidance throughout the process.

3.2 *Common carriage*

Common carriage is important to the development of more market competition. Competitors need to be allowed to share the monopoly inherent in water and sewerage networks, on fair terms. It is reasonable to expect companies to be able, six months after CA98 came into force, to hold detailed negotiations with potential competitors. Consequently, companies have been asked to prepare first full versions of their access codes by 31 August 2000, building on their Statements of Principles.

The Director has not prescribed the means by which incumbents should govern the shared use of their infrastructure. He has, however, given guidance on a number of issues that each incumbent should take into account when implementing common carriage arrangements.

If the potential entrant believes the incumbent is refusing to offer terms, or offering anti-competitive terms for common carriage, it can ask the Director to investigate. The Director will decide whether the incumbent's behaviour is anti-competitive. Advice about anti-competitive behaviour on non-price terms is set out in MD162, Ofwat's approach to assessing whether companies access prices infringe CA98 or breach licence conditions is set out in MD163. To help develop the approach to assessing access prices, Ofwat formed and drew advice from the Common Carriage Consultative Working Group (CCCWG). The membership includes senior Ofwat staff, Professor Stephen Littlechild, Professor David Newbery (Director, Department of Applied Economics, Cambridge University), Kyran Hanks (Director of European Government Affairs, Enron International) and Dr Roger Corbett (Chairman, Ofwat National Customer Council (ONCC) Competition Group).

A company's access prices will be regarded as unreasonable if they limit markets to the prejudice of consumers, treat new entrants differently from the way a company treats itself or discriminate unduly between different new entrants. If the Director finds that an incumbent has infringed CA98, he will direct it to change its conduct and, if appropriate, impose financial penalties. However, the Director could find the incumbent's refusal not unreasonable if he believed the potential entrant's demands were unreasonable.

3.3 Cross border supplies

Cross-border supplies represent a more straightforward method of choosing a different supplier than the inset route and could become more important as competition develops. Any customer can connect to another undertaker's network and receive a supply, as long as the customer is prepared to pay the reasonable costs of making that connection. An anomaly that exists for the moment is that undertakers are required to make cross-border supplies for domestic purposes if asked, but are not obliged if the supply is for non-domestic purposes (although they may still do so). The Director welcomed the DETR's consultation, *Competition in the Water Industry in England and Wales*, published in April 2000, which accepted his proposal that undertakers should have a duty to provide supplies to all customers across borders on demand. To date, few customers or companies have pursued this opportunity, perhaps because they have been unaware of its existence or because of the cost compared with the potential benefits. However, the expansion of the duty for undertakers to supply all customers who demand a supply across borders may promote an expansion of competition at the margin.

3.4 Contracting out

Companies already subject some of their operations directly to market competition via competitive tendering. An extension of these arrangements would be the complete separation of asset ownership from operation, as has been proposed, for example, in Kelda's plans for the restructuring of Yorkshire Water. Companies pursuing contracting out arrangements must maintain sufficient control over operations to ensure proper service to customers and to the environment. Moreover,

the Director will expect contracts to be let in such a way as to avoid a significant reduction in market competition or comparative competition in the supply of operational services.

3.5 *Partnership arrangements*

Partnership arrangements between customers and suppliers are an increasingly important area for competition. Partnerships enable the supplier to look for ways of reducing the costs incurred by the customer and can reduce the supplier's costs. Arrangements may include account management, where a customer can have all of the water and sewerage services across a number of sites managed under one account. Alternatively, the supplier may provide an on-site management service where a customer can be helped to manage consumption, or reduce the volume and strength of trade effluent to make it cheaper to treat.

3.6 *Abstraction licensing*

Trading of licence rights has been demonstrated in other countries to yield clear economic and environmental benefits. It is crucial to the development of competition in the provision of resources and will enable new entrants to enter the market. The Director welcomed the DETR consultation *Economic Instruments in Relation to Water Abstraction*, published in April 2000, which consulted on *how*, not *whether*, abstraction licences will be traded. He is pressing for local Catchment Abstraction Management Strategies to make clear in advance how existing licences will be managed in the event of an application for a transfer.

3.7 *Companies' tariff policies*

As competition develops, companies may wish to bring their regional average tariff structures more closely into line with local costs. Should they choose to adjust their tariffs, water companies should generally charge prices that reflect the social, economic and environmental costs of the resources involved. For all of their operations, they must do more work to understand these costs. This will allow suppliers to charge by a differentiated tariff where customers can choose the service and tariff that meets their need, at a charge which reflects the costs of providing that service. However, any de-averaging would have to be consistent with the Director's duty to protect the interests of customers, particularly those in rural areas.

3.8 *Other opportunities*

The competitive opportunities outlined in this section are not exhaustive, the Director expects that more openings for companies and customers will come about as a result of the Government's Review of Competition, and as new ideas develop within the industry.

4 Achievements of competition

To date, there have been eight insets granted, for three large users and five greenfield sites (two of which had been privately supplied). One of these greenfield site insets is for an area that will be developed for residential purposes. It is the first time that new households have, via the housing developer, chosen a different supplier.

A further six applications have been given the go-ahead and the final decision rests with the customers concerned. Ofwat is also working with a number of companies to develop their proposals for more insets. There are around 12 of these proposals. Anglian Water has announced that it is pursuing 55 competitive opportunities and Enviro-Logic has around 200 such opportunities.

The introduction of the first new licensed water company since privatisation was a significant milestone. In May 1999, Albion Water (Shotton) Ltd, a subsidiary of Enviro-Logic, became the water undertaker for a large user in North Wales, in place of the incumbent Dwr Cymru.

As mentioned earlier, cross-border supplies could become more important as competition develops. In May 2000, Thames Water announced it would provide a cross border supply to the Brands Hatch motor racing circuit. The customer estimates saving around 20% on its annual water bill and expects to receive a more reliable service.

Partnership arrangements can be made without consultation with the Director, therefore it is not clear how many such arrangements exist between suppliers and customers. Two recent examples of partnership agreements that have been reported in the press were between Severn Trent Water and Northern Foods, and Northumbrian Water and Scottish Courage.

The threat of competition has delivered more tangible benefits to many more customers. Perhaps the most significant of these benefits is the introduction and development of tariffs for large users. These began as reductions from the standard tariff for users above the 250Ml/y threshold and have since been extended to include users of as little as 0.5Ml/y, as well as offering seasonal and interruptible tariffs. Many companies have large user tariffs, most of which extend the benefits to customers whose volume is below the inset threshold.

Since the provisions of CA98 came into effect, the Director has received 12 complaints. Four of these complaints are currently being considered and eight have been dismissed. Ofwat has kept the Office of Fair Trading informed of progress in consideration of these complaints. The Director will use his formal powers where an investigation finds that a company is infringing the provisions of CA98.

5 A change in attitudes

Even as little as two years ago, most water companies adopted a neutral or defensive attitude to competition. In particular, the concept of competition through shared use of networks, which had been so significant in electricity and gas, was not actively considered in water. Large users complained that insets were too complex and time-consuming to be effective. New entrants argued that there were large barriers to entry. The consensus seemed to be that there would never be a significant level of market competition in the water industry.

Now there has been a marked change in attitude. More companies positively seek out competitive opportunities. Those companies that held defensive attitudes are now largely the ones that are eager to make it work. Ofwat has shown that inset appointments can and do work. It has changed its approach to the application

procedure to one of active facilitation – it is now more proactive in communicating opportunities to potential applicants.

The introduction of CA98 has been significant in changing attitudes. It has strengthened considerably the legal powers available to the Director to prevent abuse of a dominant position and other anti-competitive behaviour. It has been a catalyst for the development of common carriage by putting incumbents at risk of abusing a dominant position if they refuse to share the use of their networks with potential new entrants, or offer unreasonable terms. The fact that many companies operate their own “internal market” in water and sewerage services, in the way they operate their systems, is significant in the development of common carriage and allows Ofwat to press incumbents to treat new entrants on a basis that is consistent with this.

An important aspect of this change in attitude is the recognition that greater market competition may be achieved via common carriage. The Director has considered carefully whether companies not licensed under the Water Industry Act 1991 should supply customers through common carriage. He believes it is not essential to be a licensed undertaker. However, the pace of market competition could be accelerated through the development of a simple common carriage licence which would extend the remit of the DWI to all supplies across public networks.

What were once regarded as problems with regard to the potential risks to water quality and public health, as well as the difficulty of developing a system successfully, are now recognised as issues that companies can address within their own networks. The fact that several water companies are working together to ensure the issues surrounding common carriage are properly addressed illustrates how much attitudes have changed.

6 The future of competition

Insets continue to be a key part of several companies’ competitive advances and cross border supplies could become increasingly important. Common carriage will occur, although we cannot predict how quickly. The Government is reviewing competition in the water industry through its consultation paper (April 2000) *Competition in the Water Industry in England and Wales*. Far-sighted companies are looking for ways to reduce costs and understand better how these should be allocated among customers.

There may even be a change in the way companies operate. The Director has suggested that, to facilitate this, it might be worth simplifying licences for companies not providing the full range of vertically integrated services. Simpler licences may allow companies to focus on separate elements of the supply chain such as transport of water and sewerage, provision of resources, treatment, disposal and retailing. These changes have been introduced into gas and electricity and could be introduced into the water and sewerage sector. They need not change the way companies operate now, but would give them the ability to consider changing in the future.

The possibilities for market competition are great. There are challenges for all participants to address. The Director will work to ensure an open and level playing field, allowing markets to work without favour to anyone, and communicate this to all interested parties. Customers can press for more choice and better service. Companies can pursue and exploit competitive opportunities and reap the benefits. They need to respond positively to all enquiries and ensure that they comply with CA98.

ANNEX

Further Reading

DETR (2000) *Competition in the Water Industry in England and Wales: Consultation Paper*.

DETR (2000) *Economic Instruments in Relation to Water Abstraction: A Consultation Paper*.

The DETR publications are available on the web site www.detr.gov.uk.

DWI (2000) *DWI Guidance on Drinking Water Quality Aspects of Common Carriage*. Available on the DWI web site www.dwi.detr.gov.uk.

OFT (2000) *The Competition Act 1998: The Application in the Water and Sewerage Sectors*. Available on the OFT web site www.oft.gov.uk.

Ofwat (1999) *Inset Appointments: Guidance for Applicants*.

Ofwat (1999) *MD154 Development of Common Carriage*.

Ofwat (2000) *MD158 Common Carriage*.

Ofwat (2000) *MD162 Common Carriage – Statements of Principles*.

Ofwat (2000) *MD163 Pricing Issues for Common Carriage*.

Ofwat (2000) *Response to the Government's Consultation Paper, Competition in the Water Industry in England and Wales*.

Ofwat (2000) *Information Note 10: Market Competition in the Water and Sewerage Industry*.

Ofwat (2000) *Information Note 45: Competition Act 1998*.

Speech by Sir Ian Byatt at the Economist Conference, 29 October 1999, *The Future of Competition*.

Speech by Sir Ian Byatt to the Institute of Economic Affairs Conference, 15 June 2000, *Regulatory Priorities in an Evolving Market*.

The Ofwat publications and speeches are available on the web site : www.open.gov.uk/ofwat or the Ofwat library telephone: 0121 625 1373; E-mail address: enquiries@ofwat.gtnet.gov.uk.