



Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Phone: 0121 625 1300

Direct line: 0121 625 1318 Fax: 0121 625 1379

Emma Campbell
Assistant Director
DTI Economic Regulation Team
Department of Trade and Industry
1 Victoria Street
London
SW1H 0ET

13 December 2006

Dear Ms Campbell

CONCURRENT COMPETITION POWERS IN SECTORAL REGULATION

The Water Services Regulation Authority (Ofwat) is the economic regulator of the water and sewerage industry in England and Wales. We regulate the 23 water and sewerage companies that operate in England and Wales, inset appointees and water supply licensees. Ofwat was established in 1989 when the water and sewerage industry was privatised.

We welcome the DTI / HM Treasury review of concurrent competition powers in sectoral regulation. We support the report's goal of improving how concurrency works and how the regulators apply their concurrent competition powers. We will continue to work with the Concurrency Working Party (CWP) to take forward the recommendations appropriately.

One of the three aims of the project was to understand how regulators balance their concurrent competition powers with their sector-specific regulatory powers. Water supply and sewerage service provision remains a heavily regulated sector in which market competition (as opposed to comparative competition) is not widely established. In part this reflects the nature of water supply. The Government has noted that water is heavy and costly to distribute (compared with its final selling price) and there is no national grid to distribute it (paragraph 26 of the Defra consultation paper on extending opportunities for competition in the water industry in England and Wales¹). That water supply and sewerage service provision remains a heavily regulated industry with little market competition also reflects the Government's policy choices. The Government has expressed a strong preference for retaining vertically-integrated water companies (paragraph 44) and allowing competition only for non-household customers (paragraph 53). It has also set out its wider objectives for the

¹ "Extending opportunities for competition in the water industry in England and Wales – Consultation paper", Defra and Welsh Assembly Government, July 2002, can be found at www.defra.gov.uk/environment/consult/watercomp2/

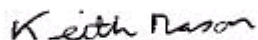
water industry (paragraph 9) which are protecting public health and the environment, meeting the Government's social goals and safeguarding services to customers.

The Government enacted sector-specific legislation to introduce limited opportunities for market competition in the water industry through the water supply licensing (WSL) regime contained in the Water Act 2003 (WA03). The legislation was enacted partly with the aim of removing the uncertainties arising from the Competition Act 1998 (CA98) about how appointed water companies should allow access to their distribution networks (paragraph 22). Market competition was not introduced to most of the water industry via this legislation; instead, it was limited to very large users of water. The Government chose specifically to prohibit market competition for "non-eligible" customers. For these reasons, water supply and sewerage service provision is likely to remain a heavily regulated industry for the foreseeable future.

Our Chief Executive, Regina Finn, wrote to Ian Pearson MP, the Minister for Climate Change and the Environment at Defra on 28 November 2006 expressing our concern about the lack of progress in the development of competition in the water industry since the WSL regime started. The letter explains that we have already initiated an internal review of those aspects of the WSL regime that are within our scope to address. We also asked Defra to start to review the key characteristics of the WSL regime that are set out in primary and secondary legislation (the costs principle and the threshold for contestability) to see if would be appropriate to change either or both of these.

Please find attached an annex setting out our detailed response to the report. We have published this response on our website.

Yours sincerely

A handwritten signature in black ink that reads "Keith Mason". The signature is written in a cursive, slightly slanted style.

Keith Mason
Director of Regulatory Finance and Competition

ANNEX

Response to the recommendations

This section sets out Ofwat's views on the recommendations contained in the report. We have co-ordinated our response with the other members of the CWP.

Recommendations 1a, 1b and 2

We have signed the joint CWP response to recommendations 1a, 1b and 2.

Recommendation 3

Recommendation 3 is addressed to the OFT.

Recommendation 4

“While in many cases it may be appropriate to exercise sectoral powers, regulators should carefully consider the grounds for deciding on the use of either competition or regulatory powers in economic regulation and give clear explanations for their decisions.”

We already carefully consider which of our powers are most appropriate when dealing with a particular case and we will continue to do so. We explain in our “Report on competition complaints 2005-06” (paragraphs 2.3 to 2.7) how we assess new complaints. At paragraph 2.6 of that report we also explain that where a complaint raises issues which might fall within the scope of both the Water Industry Act 1991 (“WIA91”) and the CA98, we have discretion to decide on the most appropriate powers to use.

We consider every complaint on its merits, but if there is specific water industry legislation which could be used to address an issue it can often produce a faster and more targeted solution for the parties involved and be less resource-intensive to use that legislation. At the same time, we believe that the CA98 has an important role in the water industry and we will continue to use it where appropriate and proportionate to do so. We explain our decisions to complainants and we will continue to do this.

Conclusion on recommendation 4

We will set out publicly the factors we take into account when assessing whether to use sector-specific or CA98 powers. We will do this in our next annual report on competition complaints and our revised CA98 guidance for the water and sewerage sectors (which is currently under revision).

Recommendation 5

“Sectoral regulators should consider the ways in which they are preparing to withdraw from economic sectoral regulation wherever practicable and permissible in legislation and especially in sectors where competition has developed, and should include an assessment of progress in their annual report, as, for example, Ofcom does.”

We agree with the principle that where effective market competition exists regulators should consider withdrawing from economic sectoral regulation wherever practicable and permissible in legislation. In the water industry we took large user prices out of the tariff basket in response to the growing prospects for competition.

Parliament introduced in the WA03 sector-specific legislation to introduce further competition into the water industry, through water supply licensing (WSL). This expressly allows competition via the public supply system for some large business customers and prohibits it for all others (the majority of customers). In its July 2002 consultation paper the Government acknowledged that there were a large number of uncertainties about how common carriage under the CA98 would work in the absence of water-specific legislative provisions. The Government also chose to use sector-specific legislation to support its wider policy objectives for the water industry, for example, to protect public health, protect the environment, meet the Government's social goals and to safeguard services to customers. Furthermore, Ofwat has specific statutory duties to promote competition and to implement the WSL regime. It cannot choose to ignore these duties or withdraw from them.

The WSL regime went live on 1 December 2005 and the competitive regime is still in its infancy. In the future when competition becomes more widely available in the water industry there may be more scope for withdrawing from economic sectoral regulation. Our Chief Executive, Regina Finn, wrote to Ian Pearson MP, the Minister for Climate Change and the Environment at Defra on 28 November 2006 expressing our concern about the lack of progress in the development of competition in the water industry since 1 December 2005. The letter explains that we have already initiated an internal review of those aspects of the WSL regime that are within our scope to address. We also asked Defra to start to review the key characteristics of the WSL regime that are set out in primary and secondary legislation (the costs principle and the threshold for contestability) to see if would be appropriate to change either or both of these.

For the reasons set out above, water supply and sewerage service provision is likely to remain a heavily regulated industry for the foreseeable future. Comparative competition will continue, but market competition in the public supply system is currently prohibited by statute for all but the largest business customers.

Conclusion on recommendation 5

We agree in principle that where effective market competition exists regulators should consider withdrawing from economic sectoral regulation wherever practicable and permitted by legislation. However, for the reasons set out above one of our key current areas of focus is establishing market competition in the water industry by implementing the WSL regime under the Water Act 2003. We are conducting an internal review of those aspects of the WSL regime that are within our scope to address and we have asked Defra to review the key characteristics of the WSL regime that are set out in legislation. We will continue to report on market competition in the water industry in Ofwat's Annual Report each year.

Recommendation 6

“Sectoral regulators should consider reviewing their licence conditions, with a particular focus on proving the necessity of retaining any specific licence condition in the context of the application of general competition law.”

We consider that the existing appointment conditions of water companies and the licence conditions for water supply licensees under the WSL regime are necessary for the proper carrying out of the functions of these companies. For example, when developing WSL licence conditions we aimed to strike the right balance between protecting consumers and allowing licensees flexibility to operate in the market.

There are certain limits to the extent that we can withdraw from sectoral regulation and change appointment and licence conditions. For example, we are required to act in accordance with our duties as set out in statute, such as in the CA98 and in particular in the WIA91. The conditions of appointment of water companies have an important role in relation to the functioning of the water industry in accordance with the requirements of the WIA91. It would clearly be for Parliament to amend or repeal statute, including sectoral legislation, to remove, add or modify current requirements. However, if we consider an appointment condition to have become unnecessary in line with the requirements in the WIA91, for example due to changing market circumstances, section 13 WIA91 allows us to modify an appointment condition with a company’s consent. Under section 14 WIA91 we can also make a reference to the Competition Commission (CC) to investigate and report on whether, in the public interest, a change is needed to an appointment condition. In its determination, the CC is required to consider our duties set out in Part I WIA91.

Conclusion on recommendation 6

We will continue to use appointment and licence conditions, and we will consider the necessity of retaining appointment and licence conditions as competition develops in water supply.

Recommendation 7

“Sectoral regulators and the OFT should consider whether inquiries undertaken under general competition law would be best conducted by a joint team drawn from both the sectoral regulator and the OFT in relevant cases. Decisions on which body would lead the case would, of course, need to be taken on a case-by-case basis.”

We have signed the joint CWP response which addresses recommendation 7. We agree with that response.

We would add to the CWP response that, as the report acknowledges, the process for deciding who deals with a particular complaint currently works well. When conducting our investigations and work on appeals we have liaised with

other regulators and the OFT on specific issues and to that extent there has already been joint working without the need for joint teams.

We agree that in some cases it might be useful to have joint teams between the OFT and sectoral regulators, as an extension of the co-operation that already exists. To get the most benefit from joint teams we and the OFT would have to clearly define the terms of reference for joint team working. We would want to take the lead in cases in the water and sewerage sector because we have the most expertise in the economics and the regulation of the water industry.

Conclusion on recommendation 7

We agree with the CWP response. We will consider, in appropriate cases, pooling our resources with the OFT and other regulators for the purpose of competition law investigations and inquiries. We will build the consideration of joint teams into our internal CA98 complaint procedures.

Recommendation 8

“We would encourage the regulators to think about whether they can be more proactive in using competition law, including the use of market investigation references.”

We agree with recommendation 8. It is useful that the report explains that our competition powers are wider than just CA98 investigations and include Market Investigation References (MIRs) to the CC and market studies. None of the sectoral regulators has yet made an MIR to the CC, although the ORR is currently consulting on whether to make a reference. So far only the ORR has carried out an OFT-style market study. From our perspective, this is because MIRs and market studies tackle structural features of the market which might inhibit competition, rather than specifically anti-competitive actions or agreements. We find that sectoral regulation often tackles the same structural problems. For example, the structural difficulties that made common carriage in the water industry difficult were addressed by legislation, with the introduction of the WSL regime. In addition, our CA98 investigation into tankered landfill leachate in North West England involved a detailed study of that market, similar to a market study, as part of our investigation.

Conclusion on recommendation 8

We have been aware of the option of carrying out a market study or making an MIR to the CC in the past when looking at potential competition issues, but our view has been that up to now neither has been appropriate. We will however continue to consider how proactive we can be in using competition law tools.

Additional comments on the report

In addition to our response to the report’s recommendations we have a few other comments on the report.

Paragraphs 8, 4.26- 4.28 - Appeals to the Tribunal

Your report notes that the regulators feel that there are significant costs in handling appeals and that it can be difficult for regulators (and the OFT) to close down what might be considered non-meritorious complaints.

We welcome the principle that CA98 decisions are appealable to the Tribunal. This ensures that parties involved in CA98 investigations have a specific right to appeal under the CA98. Nevertheless, we have had considerable experience in handling appeals to the Tribunal and are aware that they are long processes which impact heavily on our resources.

To date we have made four CA98 decisions but we have faced eight appeals at the Tribunal. In paragraph 4.27 your report states that the average length of appeal to the Tribunal was 7.8 months or 9.4 months (depending on the method of calculation). However, our experience is that appeals can take much longer to resolve. Table 1 shows the eight appeals we have faced and their duration.

Table 1

| Status | Appeal | Case number | Duration |
|---------------------------------|--------------------------|--------------------|------------------------|
| Withdrawn | AR v Ofwat | 1050/2/4/05 | Withdrawn |
| Stayed | ALB v Ofwat (Shotton) | 1031/2/4/04 | Stayed |
| Stayed | ALB v Ofwat (Shotton) | 1034/2/4/04(IR) | Stayed |
| Stayed | AQV v Ofwat (Shotton) | 1045/2/4/04 | Stayed |
| Judgment on admissibility | AQV v Ofwat | 1012/2/3/03 | 5½ months |
| Judgment on substance | ALB v Ofwat (Bath House) | 1042/2/4/04 | 20½ months |
| Current appeal on substance | ALB v Ofwat (Shotton) | 1046/2/4/04 | 28½ months and ongoing |
| Current appeal on admissibility | IWC v Ofwat | 1058/2/4/06 | 11 months and ongoing |

Key: ALB – Albion Water Ltd IWC – Independent Water Company Ltd
 AR - Aqua Resources Ltd AQV – Aquavita (UK) Ltd
 IR – Interim Relief

Paragraph 1.5 and 2.24

In these paragraphs your reference to the regulators’ duties to promote effective competition does not completely reflect the wording of the WIA91 (as amended). Section 2B of the WIA91 (as amended) states that “The consumer objective mentioned in subsection (2A)(a) above is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.”

Paragraph 4.8

In paragraph 4.8 the report states “some commentators have further argued that regulators may deliberately attempt to avoid exercising the Competition Act so as to

reduce the potential for conflict with the industries they regulate”. This might be the view of some commentators but we do not accept that view. When deciding which of our powers to use we choose the powers which are the most appropriate depending on the circumstances of the case.

Paragraph 4.34

The report implies that regulators can take cases to the Tribunal. As a point of clarification, regulators cannot take cases to the Tribunal. It is for the parties addressed by any decision (or a third party with a sufficient interest) to appeal a decision to the Tribunal.