

# Ofwat's consultation on its approach to competition law in England and Wales

A response from Oxera, prepared for Ofwat

January 2017

## 1 Introduction

Oxera is delighted to provide its thoughts on the application of competition law to the water sector in England and Wales, in response to Ofwat's consultation document on its draft guidance (as published in November 2016).<sup>1</sup>

As highlighted in the consultation, the water sector in England and Wales is undergoing substantial change. This includes the introduction of non-domestic retail competition in April 2017, as well as upstream reforms over the coming years. The latter include initiatives envisaged in Water 2020 (direct procurement, bidding-in markets, water trading and bio-resources markets) and changes from 2019 onwards envisaged in the Water Act 2014 (in particular, bilateral water markets).

Existing forms of competition will continue to develop in parallel—including self-lay, new appointments variations (NAVs, or 'insets'), and competition through contracting relationships at various stages in the supply chain.

As noted in the consultation, some of these arrangements will involve sector-specific codes and protocols that participants in the markets will need to adhere to. However, in as far as companies have discretion, it is their responsibility to ensure that they comply with the requirements of competition law.

Oxera has written previously on the application of competition law to the water sector and has been monitoring developments. A copy of our *Agenda* article 'In a fluid state? Competition policy in the water sector' accompanies this note, in which we discuss margin squeeze, discrimination with anticompetitive effects, and predation.<sup>2</sup> With the coming changes, it is almost inevitable that there will be complaints that trigger more of these kinds of investigations. Ofwat's guidance on its approach to competition law therefore provides welcome clarity. It also serves as a deterrent to those who might (deliberately or otherwise) engage in anticompetitive behaviour.

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<sup>1</sup> Ofwat (2016), 'Guidance on Ofwat's approach to competition law in the water and wastewater sector in England and Wales: a consultation', November.

<sup>2</sup> Oxera (2015), 'In a fluid state? Competition policy in the water sector', *Agenda*, January.

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However, there are some gaps in the guidance where further explanation would be helpful (while we recognise that being over-prescriptive can also lead to unintended consequences). We also note here some other observations and suggestions. Finally, we have identified an instance where we believe there is the potential for reader confusion, which can be reviewed and potentially corrected in the final version.

## **2 Comments on the consultation**

As noted, Oxera welcomes Ofwat's guidance on its approach to competition law, particularly as this goes further than previous guidance and provides clarity on several issues.

### **2.1 The role of the European Commission**

The draft Ofwat guidance highlights in various places the role of Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU), the provisions of which were reflected in Chapters I and II of the UK Competition Act 1998 (CA98), and which remain complementary to CA98 where there is an issue that affects competition between member states.

The legal framework could develop further going forward as a consequence of the UK vote to leave the EU. Much remains uncertain, but perhaps something noting this could be included in the final guidance as it is an issue that readers will have in mind.

### **2.2 The primacy of competition law**

On the primacy of competition law (p. 15), Oxera welcomes the clarity that Ofwat has provided on this issue—that Ofwat should assess at an early stage in any investigation whether using its CA98 powers would be more appropriate than using its sector-specific Water Industry Act 1991 (WIA91) powers.

What we would note, however, is that sector-specific powers go *further* than competition law, in that they cover compliance with ex ante obligations (such as licence conditions) rather than more general ex post competition law.

### **2.3 Multiple parties in the supply chain**

The new arrangements and interfaces that emerge over the coming years will mean that complaints become more likely than in the past.

Oxera supports Ofwat's emphasis on ensuring that all parties in the water sector supply chain—and not just licensed water companies—are aware that Ofwat can use its competition enforcement powers against them if required (see p. 18 of the guidance). Competition concerns can indeed emerge at any stage in the supply chain.

Analogously, in the energy sector, in 2007 the European Commission fined a number of suppliers of gas insulated switchgear (high-voltage electrical substations which control the power network) that had formed a cartel.<sup>3</sup> Oxera subsequently acted for National Grid in the UK to recover damages.<sup>4</sup> In this case, the conduct had an impact across member states. In cases involving only England and Wales, it is perhaps likely that the Competition and Markets

<sup>3</sup> European Commission (2007), 'Case COMP/F/38.899 – Gas Insulated Switchgear', Commission Decision relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement, Brussels, 24/01/2007 C(2006) 6762 Final.

<sup>4</sup> <http://www.oxera.com/Latest-Thinking/News/July-2014/Oxera-helps-National-Grid-achieve-settlement-in-fi.aspx>

Authority (CMA) (rather than Ofwat) would take the lead on cartel investigations; nonetheless the switchgear case illustrates that issues can emerge at any stage in the supply chain.

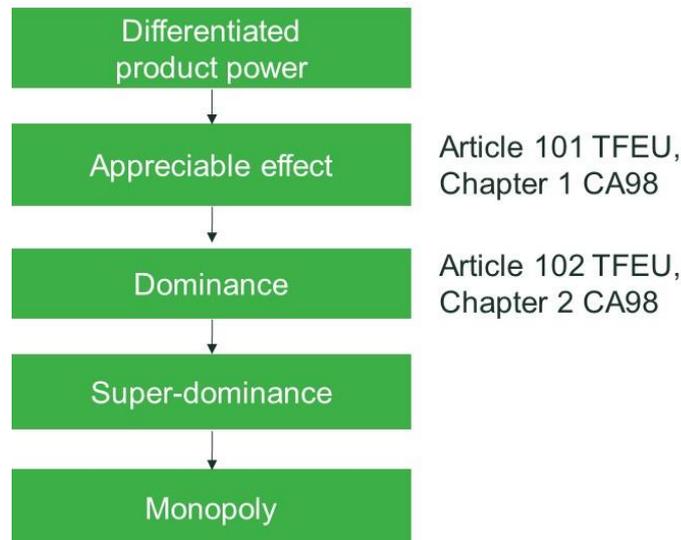
## 2.4 Thresholds for establishing market power

On p. 19 of the Ofwat consultation, the draft guidance highlights the following in relation to anticompetitive agreements:

Agreements between undertakings are more likely to have an **appreciable effect** on competition where the undertakings concerned have collectively **significant market power** within the relevant market. [emphasis added]

While this statement holds, it may lead to some confusion. Figure 1 summarises different concepts that tend to be used in discussions about market power. As shown, the threshold for appreciable effect (as part of a Chapter I investigation into anti-competitive agreements) is lower than that for dominance (which is equivalent to the notion of significant market power, or SMP in a Chapter II abuse of dominance case)—in fact, the threshold is *much* lower.

### Market power



Source: Oxera.

This difference in thresholds is, for example, acknowledged elsewhere in Ofwat's draft guidance. On p. 24 it is stated that, having regard to the guidance of the European Commission, there would be no appreciable effect on competition under Article 101(1) if the parties' combined market share does not exceed 10%.<sup>5</sup> As noted on p. 28, the threshold for dominance (or equivalently SMP) is much higher:

In developing the case law on dominance, the courts have stated that dominance can be presumed, in the absence of evidence to the contrary, where an undertaking has a market share persistently above 50%. Dominance has rarely been established in case law where an undertaking has a market share of below 40%, but this does not mean dominance in such cases may not be possible depending on features of a particular market.

<sup>5</sup> European Commission (2001), 'Notice on agreements of minor importance which do not appreciably restrict competition under Article 101(1) of the Treaty on the Functioning of the European Union', OJ 2014 C 291/1.

We would also highlight that the European Commission's safe harbour thresholds do not apply to 'hard-core' restrictions that have as their object the prevention, restriction or distortion of competition within the internal market (agreements that 'obviously' harm the competitive process and/or have been deemed unlawful per se in prior cases, as noted on p. 23). Price-fixing, restriction of output and market-sharing all come under this category. As such, in these cases it is not necessary to establish market shares of any magnitude. For example, if a selection of small suppliers of maintenance services to a large water company colluded as part of a bid-rigging operation, it would not be necessary for the investigating authority to establish that the parties had material market shares in order to conclude that the arrangement was anticompetitive.

That said, there is a case for the investigating authority to *prioritise* investigations where the participants in a cartel have more material market shares. Prioritisation should also be based on the likely *effect* of the anticompetitive conduct (as well as the form of conduct—a point we return to below).

## 2.5 Customer sophistication and behavioural biases

With retail market opening for non-domestic customers from April 2017 onwards, it is important that firms compete to win customers through competitive pricing and service, as opposed to through the exploitation of behavioural biases (such as loss aversion, present bias or information overload).

Where consumers have limited scope for learning, or where they exhibit behavioural biases, they may not switch as readily as standard economic theory would predict; or, if they do switch, they may switch to a deal that is not good for them.

In markets where there are single pricing points, sophisticated consumers, who do shop around and do secure good deals, protect those less active in the market. However, this is not necessarily the case if firms can target their product offerings, multiple-pricing, distribution, marketing and contracting arrangements in a way that discriminates between sophisticated and 'naive' consumers, such that the sophisticated consumers get good deals at the expense of the naive ones (through cross-subsidies). For example, a concern could emerge in the water sector if much smaller non-domestic retail customers (such as corner shops) do not engage with the market, with the focus of water retailers being solely on large and sophisticated multi-site players (such as chain stores).

Moreover, observing a high number of firms in place in the market does not necessarily solve this problem—indeed, in certain situations, it may exacerbate it.

We would argue that, as part of any CA98 investigation, Ofwat needs to consider carefully the *demand side* of the market, to examine whether there are 'pockets' of market power that might not ordinarily be picked up in the established way of assessing dominance (which focuses largely on *supply-side* considerations such as market shares and barriers to entry). This assessment needs to be evidence-based, using observed field data, laboratory experiments and field trials. Any existing protections for smaller non-domestic customers should be taken into account.

There is also the question of whether any issues are best dealt with through competition law or instead through sector-specific regulation.

## 2.6 Forms of conduct and effect

The list of anticompetitive exclusionary practices that may be of concern under Chapter II of the CA98 is not intended to be comprehensive, and there is a reference to the (formerly named) Office of Fair Trading guidance on various types of conduct.

Perhaps more could be said on discriminatory behaviour. Price or non-price discrimination are not prohibited under competition law *per se*, as discrimination can be output-enhancing. However, discrimination is of concern where it is of a particular *form* and/or where it can be shown that it is more likely that there will be exclusionary *effects*. The 2013–14 Bristol Water self-lay case is arguably one in which Ofwat had such concerns. (The case was discussed in the Oxera *Agenda* article on the application of competition policy in the water sector.<sup>6</sup>)

The comment in the consultation document on bundling and tying is of interest (p. 30) as one way in which bundling or tying can be anticompetitive is when a dominant position in one market (A) is leveraged *horizontally* into another market (B). This is discussed in a *vertical* sense on p. 31, but leveraging between markets can also take place horizontally. Dominant companies will need to be aware of how they bundle offerings in the non-household retail market— notwithstanding that many forms of bundling are pro-competitive, efficient and serve customer needs.

## 2.7 Imputation tests and cost thresholds

Oxera observes that little detail is provided in the Ofwat consultation document on the price–cost tests that would be used to assess predation cases or the imputation tests in margin squeeze cases. Also, there is little detail on the cost benchmarks that would be used in either type of case (see pp. 31–32).

In respect of the types of test, in considering a margin squeeze case (and a discrimination case), Ofwat has previously referred to the concept of whether an ‘equally efficient’ operator would be able to compete. However, little further detail has been provided in the latest consultation document on the intended approach.<sup>7</sup>

We also note that cost concepts such as long-run incremental cost (LRIC) are in the process of being developed in the water sector.

## 2.8 Other issues

There are some other issues that Oxera would highlight:

- While case law precedence has tended to be focused on the form of conduct, our assessment is that best-practice should be to focus on likely effect as well—regulators and the European Commission are moving towards this approach, particularly in the case of prioritisation (see pp. 31–32).
- The Deutsche Telekom margin squeeze case is important in terms of the role of sector rules versus competition law.<sup>8</sup> This reinforces the point that, in so far as a dominant company has discretion in the way that it implements sector-

<sup>6</sup> For a discussion see Oxera (2015), ‘In a fluid state? Competition policy in the water sector’, *Agenda*, January. Ofwat (2014), ‘Notice of intention to accept binding commitments from Bristol Water plc in relation to the market for services for new water connections’, 22 May.

<sup>7</sup> See the discussion of the Anglian/Fairfields and Bristol Water/self-lay cases in Oxera (2015), ‘In a fluid state? Competition policy in the water sector’, *Agenda*, January.

<sup>8</sup> European Commission (2003), Deutsche Telekom AG, Decision of 21 May 2003 relating to a proceeding under Article 82 of the EC Treaty, 2003/707/EC.

specific rules and codes, or has the ability to raise issues of potential concern with the regulatory body, it is no defence to argue that just because regulations require or permit certain forms of pricing conduct, this negates the possibility of falling foul of competition law (see p. 33). The consultation document mentions legal requirements that may indeed negate this responsibility, but it would be useful for Ofwat to outline examples in the final guidance.

- The consultation document highlights the possibility of follow-on damages (p. 34), although we would note that these would rely in part on a positive anti-competitive ruling by Ofwat (or the CMA). In this regard we would note that Ofwat has not (to date) definitively concluded a case along these lines (cases have stopped following the subject of the investigation offering binding commitments, for example).<sup>9</sup> Notwithstanding this, commitments (discussed on pp. 49–51) are a useful part of the toolkit.
- Case prioritisation is important, and could include as a criterion the likely effect of the conduct concerned on the competitive process (see p. 39).
- Concurrency is an important issue. We would highlight that, under the new concurrency regime, there will be an onus on Ofwat to be proactive in investigating allegations of anticompetitive behaviour (see p. 41).
- Ofwat *could* set out more detail on its penalties methodology (pp. 48–49); for example, on the treatment of the seriousness (or ‘gravity’) of the offence, the treatment of aggravating and mitigating factors, and the overall caps on penalties. While there is a trade-off between prescription and flexibility, setting out these factors can heighten the deterrence effect while providing a consistent basis for Ofwat’s decision-making.

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<sup>9</sup> See Oxera (2015), ‘In a fluid state? Competition policy in the water sector’, *Agenda*, January.