

Agenda

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Water competition: a clear way forward?

The Cave review of the water sector in England and Wales sets out a vision that could result in major changes. But how clear is this vision, and what remains uncertain? What competition law and merger issues could emerge in future? And what are the key network regulation aspects of the review?

Published just before the 2009 Budget, the eagerly anticipated Cave review could pave the way for major reform of both competition and the regulatory regime in the England and Wales water sector.¹ Professor Martin Cave outlined a number of the main findings from his review in the May issue of *Agenda*.²

This article considers the main messages of the Cave review, and the issues that remain to be resolved. Will retail competition be straightforward to implement, and what is the future for competition upstream? What competition law issues might arise in future, and what does the review mean for regulation, going forward?

Reform is already on the horizon. The April 2009 Budget report commits the government to consulting on legal separation to drive retail competition, and on reform of the mergers regime.³ Given that Ofwat, the industry regulator, had already examined the introduction of retail competition prior to publication of the review, the current momentum is not surprising.⁴ However, the Cave review's proposals on merger reform really are 'news', and Ofwat's forthcoming response is awaited with interest.

Is retail competition resolved?

Is retail competition in England and Wales an open-and-shut case? Certainly it looks set to happen, yet there are important questions to be addressed in implementing it.

Much of the analysis of the potential benefits and costs of retail competition outlined in the Cave review is based on the Scottish experience, following the opening of the retail market in April 2008. Nonetheless, the review does highlight the differences between the market in England and Wales and that in Scotland. Some of these differences do not appear to have been given much weight in the final analysis, while others have not, explicitly, been taken into account at all. To what extent do these differences matter?

Consolidation. One major difference is that, in Scotland, vertical separation took place following horizontal consolidation, rather than prior to it. Separation on this basis allowed common standards and systems to be established across the three former Water Authority areas, before the separation of Business Stream from Scottish Water. Interfacing the retail side of Business Stream with the wholesale side of Scottish Water and introducing switching protocols were therefore more straightforward. In contrast, retail separation in England and Wales could involve 21 companies with 21 different retail systems, which would then (in most cases) each be split into two separate entities. Industry-wide uniformity in standards between the retail and wholesale interface will be crucial—but could be difficult to achieve.

Focus. A second factor is that Business Stream deals solely with non-domestic customers. This stems, in part, from historical accident: in Scotland, water bills are distributed with council tax bills, with responsibility for billing vested with the local authorities. This not only simplifies the separation process discussed above, but also has an impact on the competitive dynamic.⁵ Business Stream wears one hat—it focuses squarely on offering price-competitive and value-added service propositions to commercial customers. In contrast, the separation process envisaged in England and Wales would see retail businesses wearing two (potentially three) hats: domestic, regulated, and (regulated/competitive) non-domestic. Given that these entities will be engaged, almost exclusively, with domestic customers, will they be as focused as Business Stream on delivery in the competitive market? To achieve this focus, further business separation at the retail level could occur, although this too has its costs.

Efficiency. As acknowledged by the Cave review, partly as a result of the water industry in England and Wales having been subject to regulation for considerably longer than Scotland, more efficiencies

A rough guide to the Cave review

The scope of the final Cave review was significantly more extensive than the interim review of November 2008, which focused on measures to extend retail competition.¹

- **Increased eligibility.** The interim review proposed extending retail competition to a wider range of non-domestic customers by lowering the eligibility threshold from the current 250 megalitres (MI) per year to 5MI and subsequently to 1MI.
- **Increased coverage.** The interim review proposed extending retail competition from water services to include waste-water services.
- **Business separation.** The retail side of the business of water companies would be legally separate from network businesses.
- **Network access.** Current arrangements would be replaced with more flexible access pricing principles to ensure that retail entrants earn a ‘fair margin’.

The final review puts forward recommendations on a series of other issues, in addition to the above. The more ‘concrete’ of these, for implementation between 2010 and 2015, include the following.

- **Reforming abstractions.** Granting the Environment Agency greater powers to tackle over-abstraction, and removing current obstacles to the trading of abstraction licences.
- **Regulatory measures.** These include stipulating a duty for Ofwat to promote innovation; creating an

industry-funded body to coordinate R&D activity; providing incentives to correct bias towards capital expenditure solutions; and providing greater scope for bilateral negotiation of service standards.

- **‘Market-like’ measures.** The review encourages companies to look beyond self-provision of assets, and to seek solutions within their own company boundaries through the introduction of an economic purchasing obligation on companies, requiring the procurement of upstream solutions at best value, subject to analysis by a ‘procurement panel’. This would be coupled with the introduction of an upstream-only licence for entrants and modification of the existing access pricing rules (through the removal of the Costs Principle).
- **Merger reform.** Perhaps the most unexpected—and the most radical—proposal of the final review concerns the removal of ‘retail-only’ mergers from the special mergers regime in water, and (for the remainder of the supply chain) the raising of the turnover threshold for mandatory references from £10m to £70m—the standard threshold for other merger references. Mergers above this threshold would also, in the first instance, be referred to the Office of Fair Trading rather than directly to the Competition Commission.

In addition to the above, the final review introduces some important modifications to the interim proposals for retail competition. The review sees practical benefits in abolishing altogether the eligibility threshold for non-domestic customers, and accepts that legal separation may not be the best solution for the smallest water companies.

Note: ¹ Cave, M. (2008), ‘Independent Review of Competition and Innovation in Water Markets’, November.
Source: Oxera analysis.

have already been realised. The cost savings of introducing competition could therefore be lower.

This does not mean that retail competition will not work in England and Wales. Even though retail represents only a small part of the supply chain, competition here has the potential to fundamentally change companies’ mindsets, particularly with regard to their business focus and how they approach customer value. The retail experience will also be a test bed and could pave the way for upstream reforms at a later date. However, from a practical perspective, it will be important to take account of the above issues in the way that retail competition is approached.

The upstream dilemma

What is clear from the Cave review is its nervousness regarding introducing upstream competition. While it proposes some measures that could assist this—including modification of abstraction reforms, the introduction of upstream-only licences, and changes to upstream access rules—it does not envisage a strong case for widespread upstream competition ‘in the market’. Why is this?

‘**In the market**’. More advanced models examined in the Cave review would, to some extent, match those of the GB energy market, with fairly extensive continual selling and buying on the part of suppliers and retailers—either through a mandatory central pool or through bilateral negotiations. The Cave review does not recommend (at least the ‘broader’) variants of these options at this stage because the potential efficiency benefits appear to be outweighed by potential increases in financing costs—the latter stemming from a higher-risk operating environment and transitional issues (including debt renegotiation costs and the impact of the current economic climate).

‘**Market-like**’. The review recommends, in the shorter term, a more limited ‘market-like’ model with consideration of a ‘for the market’ model from 2015. This reflects the ‘trust and verify’ approach adopted by the review, with the most favourable risk–reward options adopted first, and subsequent measures adopted in light of that experience. While this seems sensible, it does mean that the end goal seems somewhat different to that in other sectors, since more

advanced upstream competition models are off the radar, at least for the time being.

‘For the market’. The ‘for the market’ model, which the Cave review appears to favour in the medium term, would involve establishing an independent contracting entity. This would plan resources, invite tenders for the supply of services at least cost (including contracts to build assets, and for the provision of treated water per se), and commission the most competitive of the incumbent undertaker, its neighbours, or new entrants. The review sees this strategy as offering a better-value compromise in terms of efficiency versus financing. Unlike competition ‘in the market’, the ‘for the market’ model would also apply to several aspects of the upstream supply chain (including distribution), and could be rolled out across England and Wales. However, the review leaves a number of questions unresolved, including whether the incumbent would remain responsible for the procurement role under transition; whether the commissioning function would apply to all or new assets; and the extent of ‘asset-build’ versus ‘water-supply’ commissioning.

Abstractions. What could assist entry—under any of the upstream competition models—is reform of the water abstractions system. To enter the industry, an entrant would need to apply either to the Environment Agency for a new abstraction licence or obtain one through a trade. The Cave review, building on analysis undertaken by the Environment Agency and Ofwat, sets out a twin-pronged approach: reducing overall volumes in over-abstracted areas, and facilitating a better-functioning trading market.⁶

The review outlines a number of options for tackling abstraction, including the introduction of scarcity charging by the Environment Agency where abstractions are unsustainable—with the proceeds being used to ‘buy back’ abstraction licences via auctions. Abstraction licence trading might, in turn, be assisted by the publication of trading price information and by licence terms being made more flexible. Nonetheless, an important issue will be the extent to which the Environment Agency relies on price signals versus a command-and-control approach to achieve a more effective allocation of resources. Scarcity charging, for example, could result in price rises for end-consumers, and the Australian experience suggests that the buy-back process can be expensive.⁷

There are clear parallels between the debate on the pricing of upstream resources in the Cave review and similar discussions taking place in other infrastructure sectors where upstream capacity constraints may affect the market. One example is the European Commission’s attempt, over a period of many years, to introduce a more transparent market for slot capacity at congested airports to ensure that capacity is used efficiently. Similarly, following the introduction of

competition in the energy sector, the European Commission has mandated the replacement of grandfathering rights on transmission capacity between markets with periodic auctioning of capacity to market participants.

Water, competition law and mergers

A number of competition law and merger issues have also been raised by, or relate to, the Cave review.

Mergers. Under the special mergers regime in water, any merger between two companies, each with a turnover of more than £10m, is automatically referred to the Competition Commission (CC).⁸ The Cave review recommends raising this threshold to £70m, making the treatment of this sector more consistent with others in the UK. In addition, the review proposes the removal of the automatic referral provision. The water sector would thus be subject to a two-phase merger regime, with the Office of Fair Trading (OFT) providing an initial analysis and referring only those mergers that might result in a significant lessening of competition, or which might impair Ofwat’s ability to regulate.

On the face of it, these changes may make mergers in the water sector significantly more attractive. Some mergers (eg, acquisitions of small water-only companies) may fall beneath the revised threshold, while others, no longer facing automatic referral to the CC, would be dealt with exclusively by the OFT. Two points are worth highlighting, however.

- As noted in the Cave review, under general merger inquiries, a phase 1 examination by the OFT is triggered not only where the acquired company has a turnover of £70m, but also where the combined entity has a 25% share of the supply of ‘goods or services of any description’ (and where the merger would give rise to an increment in that share of supply). However, the Cave review does not state whether the latter part of the general test should also apply to reform of the special merger regime in water. If introduced, this additional 25% provision could be used to capture many water mergers that would otherwise fall below the £70m threshold since, in practice, the OFT has broad discretion in interpreting what is meant by ‘any description’.⁹
- A further point is that the OFT has shown a willingness to undertake complex analysis in phase 1 investigations; the recent Co-op/Somerfield merger saw the examination of more than 40,000 consumer questionnaires, and was described as ‘probably the largest consumer survey ever conducted in a merger case’.¹⁰ As such, while mergers may not be referred to the CC as a matter of course, detailed analysis may still be required at phase 1.

Importantly, the Cave review has recommended that Ofwat publish guidance on its approach to assessing the loss of a comparator, setting out the methodology used. This would, of course, inform its own advice to the OFT about the extent to which a merger might impair Ofwat's ability to regulate effectively. In addition, the OFT and the CC are currently undertaking a joint review of the general merger guidelines, which could also have an impact on the roles and approaches adopted at phase 1 and phase 2.

Margin squeeze. Another important feature of the Cave review concerns its proposed reform of the access pricing framework, suggesting the replacement of the Costs Principle with a more flexible alternative.¹¹ However, the review is not completely clear on what such an alternative regime should look like. Where an entrant provides its own upstream assets, the review favours an access price based on 'full economic costs'. Should this be interpreted as 'cost-plus' pricing of the network? Regarding retail entry downstream, the review favours an approach based on 'long-run avoidable costs'; should this be interpreted as retaining a retail-minus system but with a larger 'minus' component?

In this context, the *Albion Water* case is an example of where a competition authority (here, the Competition Appeal Tribunal) ruled against Ofwat, whose view was that there was no margin squeeze.¹² In particular, the Competition Appeal Tribunal criticised Ofwat's interpretation of what the (sector-specific) Costs Principle meant for retail-minus pricing and, in this context, Ofwat's approach to testing for a margin squeeze. More generally, the *Deutsche Telekom* case shows that, even if an access regime is mandated under sector-specific rules, this does not protect incumbents from being found to have engaged in an abuse of dominance under general competition law via instigating a margin squeeze (especially if the incumbent has discretion in interpreting the rules).¹³ As such, there remain important challenges ahead in clarifying what approach is appropriate in the water sector.

Regulatory reform

Many of the reforms proposed by the Cave review in the shorter term are regulatory (or quasi-regulatory—eg, 'market-like' reforms and separation) rather than targeted solely at the competition regime.

Market failure. The Cave Review recognises that, under the current system of economic regulation, companies do not have sufficient incentive or ability to undertake R&D. For example, companies investing in R&D might be penalised under Ofwat's comparative efficiency models, which means tougher price limits.

The review also highlights the lack of positive incentives and funding for companies to undertake early stage R&D—in particular, collaborative R&D.

The net result appears to be low levels of R&D, which could be detrimental for longer-term innovation. In effect, the Cave review acknowledges that market failures are present, and that rivalry between companies—either through the regulatory regime or through market competition—is not always desirable.

The encouragement of R&D has been adopted in other regulated industries including, for example, the Innovation Funding Initiative, operating across the electricity distribution sector and adopted by Ofgem in 2004. This scheme provides opportunities for operators to bid for a fixed proportionate contribution to projects, which would otherwise not be commercially viable, but which may, nevertheless, have a number of wider social benefits. Several of the options examined in the Cave review may be of interest to utility companies in other sectors, including the removal of R&D from efficiency comparisons; the creation of an industry body; the extension of the payback period for R&D investments; and the ring-fencing of R&D budgets.

Separation. Retail separation, as recommended in the interim and final Cave reviews, will first require accounting separation. Ofwat has begun consultation on how operating and capital costs might be allocated across the (entire) value chain to facilitate this.¹⁴ One consideration here is that, while many costs are directly attributable, others are shared across activities. Nonetheless, the most challenging issue—and one which Ofwat is soon to investigate—concerns the allocation of the regulatory capital value (RCV) across the upstream, retail and other parts of the business.

One option might involve the allocation of the total RCV by book value—a potentially unfocused approach. A more targeted approach (at least according to the Cave review) might involve the subtraction of a derived market value (for the contestable retail and upstream businesses) from the overall RCV, and the subsequent allocation of remaining value across the network. Either approach could have material implications for investors. In this regard, the Cave review indicates that more advanced models of upstream competition, coupled with a focused approach to the RCV, could increase financing costs. It acknowledges, however, that a purely unfocused approach could limit prospects for entry. At present, this delicate balancing act remains unresolved. However, with regulators in other sectors (such as airports) considering a move away from RCV-based approaches to the setting of network prices, the long-term progress of this debate will be of significant interest to the industry.

- ¹ Cave, M. (2009), 'Independent Review of Competition and Innovation in Water Markets: Final Report', April.
- ² Cave, M. (2009), 'What Does the Cave Review Mean for the Water Industry?', *Agenda*, May. Available at www.oxera.com.
- ³ HM Treasury (2009), 'Budget 2009: Building Britain's Future', April.
- ⁴ Ofwat (2008), 'Ofwat's Review of Competition in the Water and Sewerage Industries: Part II', May.
- ⁵ While the Cave review appears, to some extent, to have considered the cost aspects of this particular difference between England and Wales and Scotland, it did not explicitly consider the effect on the benefits side (here, the effect on competitive dynamics).
- ⁶ Ofwat and the Environment Agency (2009), 'Review of Barriers to Water Rights Trading: Final Report', February.
- ⁷ The Australian government is committed to spending AU\$3.1 billion on buying back abstraction entitlements in the Murray-Darling Basin. Australian Government (2009), 'Restoring the Balance in the Murray-Darling Basin', March.
- ⁸ Office of Fair Trading (2003), 'Mergers: Substantive Assessment Guidance', para 9.12.
- ⁹ Office of Fair Trading and Competition Commission (2009), 'Merger Assessment Guidelines: A Joint Publication of the Competition Commission and the Office of Fair Trading—Consultation Document', April, para 3.31; and Office of Fair Trading (2003), 'Mergers: Substantive Assessment Guidance', paras 2.3–2.5.
- ¹⁰ Office of Fair Trading (2008), 'OFT Considers Grocery Store Divestments in Co-op/Somerfield Merger', press release 120/08, October 20th.
- ¹¹ For Ofwat's interpretation of the Costs Principle, and the barriers to competition created by this, see Ofwat (2008), op. cit., and Ofwat (2009), 'Ofwat's Response to the Interim Report of the Independent Review of Competition and Innovation in Water Markets', January 19th.
- ¹² Competition Appeal Tribunal (2006), '*Albion Water Limited & Albion Water Group Limited v Water Services Regulation Authority* (Dŵr Cymru/Shotton Paper)', Judgment, Case 1046/2/4/04, [2006] CAT 23, October 6th; and Competition Appeal Tribunal (2006), '*Albion Water Limited & Albion Water Group Limited v Water Services Regulation Authority* (Dŵr Cymru/Shotton Paper)', Judgment, Case 1046/2/4/04, [2006] CAT 36, December 18th.
- ¹³ Court of First Instance (2008), '*Deutsche Telekom AG v Commission of the European Communities*', Judgment, Case T-271/03, April 10th.
- ¹⁴ Ofwat (2009), 'Accounting Separation: Consultation on June Return Reporting Requirements 2009–10', March.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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