WATER INDUSTRY COMMISSION FOR SCOTLAND

OPINION

DRAFT WATER BILL - IMPLICATIONS

1. I am asked to advise the Water Industry Commission for Scotland ("WICS") on a number of highly complex matters arising from the Water Bill, currently before Parliament. WICS' concerns relate primarily to the means by which competition may be introduced in England and Wales, and the implications that this might have for water and sewerage tariff rebalancing; secondly, WICS has concerns that the regime south of the border may have implications for the manner in which regulation is conducted in Scotland and, in particular, how upstream competition may be introduced. The underlying concern is that policymakers may be constrained by considerations of European competition law. I will describe the existing Scottish regime, the proposals in the Water Bill, and analyse the latter by reference to European competition law.

The Scottish Regime

2. Under section 4 of the Water Services etc (Scotland) Act 2005 ("the 2005 Act") it is an offence to introduced water into the public water supply system or to use the public water system for the purposes of supplying water to the premises of another person, or to make arrangements for or in relation to the supply of water to the premises of another person through the public water supply system. Statutory exceptions to this are found at section 4(4) where the prohibition does not apply to Scottish Water or to another person if (and to the extent that) the person is acting on behalf of Scottish Water or under its authority.

3. Section 4(7) empowers Scottish Ministers to make regulations to specify other circumstances in which the prohibitions do not apply or which persons or categories of persons may be exempted from the prohibitions. But section 4(9) limits this power to make regulations if the effect of the regulations would not be to prejudice the exercise of Scottish Water's core functions as respects the supply of water.

4. The effect of these provisions is to prohibit common carriage and section 5 provides in similar terms for public sewerage systems.

5. An immediate issue is therefore whether the provision for authorisation in section 4(4)(b) creates problems insofar as the withholding of authorisation by Scottish Water of any of the activities otherwise prohibited in section 4(1), (2) and (3) might constitute an abuse of Scottish Water's dominant position contrary to, in the United Kingdom, the Chapter II prohibition in the Competition Act 1998 ("the 1998 Act") or Article 102 of the TFEU.

6. I am assuming that Scottish Water occupies a dominant position in the supply of water within Scotland. It is a monopoly supplier, and is constituted as an "*undertaking*" within both the 1998 Act and Article 102 of the TFEU. The 2005 Act confers a legal power on Scottish Water to grant authorisations and, subject to my comments below, it follows that, absent any other consideration, that power must be exercised in conformity with the obligations owed by any undertaking in a dominant position to act in a manner which does not distort genuine competition, that is, it must not abuse its dominant position.

7. Pausing there, I note that the provision in section 4(4)(b), which permits Scottish Water to appoint an agent or confer authority to do the matters otherwise prohibited, sits oddly with the general power to make regulations to disapply these prohibitions under certain specified circumstances or in respect of any nominated person or category of persons. The latter provides

for ministerial oversight, subject to the duty to consult found in section 4(8) and is only to be exercised without prejudice to the exercise of Scottish Water's core functions. It is at least possible that the power to appoint an agent or to authorise another person found in section 4(4) does not confer an indirect duty to authorise common carriage within Scotland but is designed to constitute a more modest objective, namely to empower Scottish Water to appoint an agent or to authorise a third party, possibly in circumstances where for practical reasons Scottish Water could not fulfil these functions itself.

8. It is odd that procedural stipulations and political oversight should exist here if Scottish Water had unreviewable powers to achieve the same object by simple authorisation. And, to the extent that a broader exemption to the prohibition is found, it is found exclusively in the context of the regulations made subject to the above conditions and qualifications.

9. Therefore, notwithstanding the changes indicated in the Water Bill, while I see the force in the argument that section 4(4)(b) *could* be interpreted as the means by which indirect pressure, on pain of proceedings under the 1998 Act, common carriage could be introduced, in my view, this would not be an appropriate interpretation given the existence of explicit regulatory powers found in section 4(7). However, unless and until this proposition is tested there must be some residual uncertainty. Scottish Water is therefore at risk, which I judge to be small, that a party seeking authorisation in order to exploit common carriage under the existing legislation in Scotland would seek a mandatory order requiring authorisation by Scottish Water on the basis that any refusal which could not be objectively justified would constitute a breach of the competition laws. Unless instructed to the contrary, I regard the possibility of separate administrative proceedings by the OFT as most unlikely under these circumstances.

10. This residual uncertainty would be avoided if section 4(4)(b) was deleted. Scottish Water's interest in authorising third parties in certain circumstances would be preserved as to fall within those "*other circumstances*" which may be permitted under the regulatory power in section 4(7).

11. In summary on this point, if Scottish Water is indeed entitled to grant authorisation leading to common carriage and refuses to do so, it is vulnerable to an action under the chapter II prohibition in the 1998 Act and Article 102 of the TFEU. If it has no such power, focus turns to the legality of the statutory regime under which it must operate and the exercise of powers by Scottish Ministers.

12. Turning to the regulatory power itself, the question would still arise whether Scottish Minsters would be under any duty to permit common carriage by the exercise of their regulatory powers.

13. The likely sequence of events would go like this. A third party undertaking would first seek authorisation from Scottish Ministers. This would be refused. The third party would then seek judicial review of the exercise of Scottish Ministers' powers under section 4(7)-(9) and also to invoke Article 106(1) of the TFEU against the United Kingdom in the Scottish courts. Article 106(1) provides that, in the case of "public undertakings and undertakings to which Member States grant special or exclusive rights", Member States must "neither enact nor maintain in force any measure contrary to the [Treaty] rules" especially the competition laws. Thus, the United Kingdom, to which the prohibition is addressed, must avoid placing these public or privileged undertakings, of which Scottish Water is undeniably one[1], in a position where it is bound[2] to abuse its dominant position.[3] Note

[1] As a public enterprise. But even if it were privatised given that its functions are under the control of the State by means of licences: *Griffin v South West Water Services Ltd* [1995] IRLR 15.
[2] The precise degree of the causal link required is slightly unsure.
[3] Where the State action would cause even a privately owned body "inevitably" to abuse it s dominant position: Case C-41/90 *Hofner & Elser v Macrotron* [1991] ECR I-1979

that, in my view, the mere creation of monopoly by the grant of special or exclusive rights would not of itself constitute a breach of Article 106(1).

14. The mechanism would be that, on the assumption that section 4(4)(b) did not confer an obligation to authorise third parties, absent regulations, third party undertakings would be disabled, on pain of criminal penalties, from exploiting common carriage. Scottish Minsters would therefore be accused of maintaining in place a regime which, it will be said, effectively obliged Scottish Water to abuse is dominant position, contrary to Article 106(1) of the TFEU.

15. That abuse, it will be said, consists of refusing access to Scottish Water's facilities which, but for the legislation in force, would constitute an abuse of a dominant position. There is an obvious semantic difficulty here in that if Scottish Water is legally disabled from allowing its systems to be used for the purposes set out in section 4(1), (2) and (3) of the 2005 Act, its refusal of access cannot of itself be an abuse of a dominant position. It is merely compliance with the law. It is the law, or "measure" in the language of Article 106(1), which is at fault.

16. Article 106(2), however, provides that such action would be permitted by any undertaking entrusted with the "...operation of services of general economic interest" (Scottish Water) if access would affect the ability of Scottish Water to perform the functions entrusted to it. It can readily be seen, presumably by design, that this is broadly the same test as qualifies the exercise of ministerial powers that is found in section 4(9). Therefore any action would lie both in the form of judicial review, that ministers had failed to exercise their powers properly and had an infirm appreciation of what would affect the core functions of Scottish Water and/or ministerial inaction in not providing for regulations allowing third party access constituted a breach of Article 106(1), incapable of remedy by reference to Article 106(2). In truth, the nature of the action and evidence required overlaps substantially.

17. It would be for Scottish Ministers to demonstrate that the provisions of Article 106(2) are satisfied. In my judgment, the issues of network integrity and Scottish Ministers' longstanding attachment to average pricing across Scotland, with very limited exceptions, strongly suggests that neither the Court nor the European Commission, if it were ever engaged, would view with favour a third party application. It must be recognised, however, that Article 106(2) will be interpreted strictly: the United Kingdom, and Scottish Ministers, would be put to proof that the specific refusal to exempt an applicant or class of applicant was strictly necessary in order for Scottish Water to carry out the (core) functions entrusted to it. In *Corbeau*[4] the ECJ considered whether the grant of monopoly was greater than what was necessary to enable the Belgian Post Office to carry out its functions and this is the inquiry which the Scottish court would have to make, though on the degree of intensity, see below.

Implications of the Water Bill

18. I now turn to the implications of the Water Bill.

19. As WICS appointed out to the EFRA Select Committee in its evidence of February 2012, the 2005 Act facilitates entry into the retail market subject to the provision that any initiative by retailers that had a negative and unavoidable impact on Scottish Water's unit costs would be made good, on a NPV basis, at the next Strategic Review of Charges. As stated above, common carriage is prohibited, with the result that charges are not disaggregated throughout Scotland but effectively based upon average costs. By contrast, what is proposed in the Water Bill rests in part upon Recommendation 6 of the Cave Review. In summary terms, it is broad endorsement of the recommendations in the Cave Report as regards

[4] Case C-320/91 [1993] ECR-I-2533

increasing upstream competition and the encouragement of new entrants who wish to provide alternative upstream water supply services. This will involve creating a new separate wholesale authorisation which, in conjunction with a new retail authorisation, would facilitate common carriage.

20. WICS has voiced its concerns on the common carriage aspects of the earlier draft Bill and, in particular, it has concerns in relation to the tariff de-averaging which, in all likelihood, would occur under the proposals. The fear is that some household customers would see increases in their bills and that, given the existence of substantial fixed and common costs, it would be unlikely that such customers would be insulated from higher charges. Moreover, if non-household customers, located in lower than average cost areas enter into contracts with new entrants for upstream services, then those who remain will bear a higher proportion of those fixed and common costs, perhaps even an ever-increasing proportion. While WICS' concern is expressed in general terms, it is also worried that the stimulus to common carriage may encourage attempted entry into the Scottish market, possibly exploiting the provisions of section 4(4)(b) discussed above.

21. I have set out above that I regard the Scottish situation as largely secure from any successful application for common carriage, although the position is certainly not free from doubt. The deletion of section 4(4)(b) might serve to reduce such doubt, but it will not totally eliminate it given the necessity to show compliance with Article 106(2) of the TFEU. That said, I regard the position of the United Kingdom Government and Scottish Ministers to be a strong one.

22. WICS has put forward various alternatives designed to ameliorate the "*negative incidence*" of de-averaging in England and Wales. These are set out in WICS' published Technical Note No. 2 of January 2013.

23. One solution lies in charging rules making it mandatory that access to the network should be priced in a way that there would be no negative impact on the regionally averaged wholesale price. A retailer would have no incentive to purchase water at a price higher than the long run marginal cost of the source(s) that the appointed business currently uses.

24. An alternative is through using an independent procurement entity, as suggested in the Cave Report. This would create an obligation on a water company to buy services from the most efficient supplier and to average the wholesale charging levies on all customers to take account of the benefits or costs of its selection of water resources across all customers.

25. Thirdly, an alternative lies in requiring the appointed businesses to work together to build interconnectors between and within their regions allowing more sharing of water resources and the development of more joint resources where this may be cost effective.

26. The underlying concern is that if retailers can directly purchase water at a lower cost than the appointee offers, they are inevitably brought into rivalry with that wholesale business, to the detriment of all customers. What is proposed under the Water Bill is that retailers would be unable to "*cherry pick*" customers who happen to reside in low cost areas whereas in Scotland, retailers are required to buy at published wholesale charges common to all prospective customers.

27. DEFRA officials are reported as stating that "*a single buyer model/efficient procurement obligation could fall foul of competition law and EU requirements (which officials describe as a right to common carriage)*".

28. There is no right under European law to "*common carriage*". Water does not fall within any set of framework directives nor does it constitute an occupied

field in Community law. It is a matter for national governments to frame the appropriate statutory regime that each regards as appropriate.

29. "*Common carriage*" may be regarded as a right to access to certain essential facilities, in this case, transmission and distribution rights for water. In the absence of any specific provision, as the *Albion Water* litigation shows, the third party may seek access to essential transmission and distribution facilities for water which are incapable of being replicated or provided by the third party applicant. While there is no right of access to such facilities, a refusal, be it an outright refusal or a constructive refusal by way of high and unfair charges, may give rise to an action for abuse of a dominant position. To the extent that the incumbent possesses transmission and distribution facilities which are incapable of replication, that incumbent would almost certainly be regarded as occupying a dominant position thereby giving rise to an obligation not to abuse that dominant position. In the ordinary course, such a refusal, actual or constructive, would be actionable, subject to the ordinary examples of objective justification, that is, some practical impossibility or capacity difficulty or concern about payment. Absent such considerations, while there is no "*right*" to common carriage, there is a right not to be subject to an abuse of the dominant position.

30. But this misses the point. If the statutory regime precludes common carriage then, axiomatically, there can be no "*right*" employing the competition laws, because national laws have abridged such rights on a common and non-discriminatory basis. We then return to the basis of a Member State's justification, if it can be shown that any preclusion of common carriage constitutes an abuse of the dominant position, that such preclusion is justified by reference to the perceived necessity to impose such a restriction in order for the regime to work: see the discussion above in relation to Article 106(2).

31. The position in Scotland is well-established and the judges will be very reluctant to overturn the current regime or intrude into policy considerations

concerning the conduct of the publically owned water undertaking. The position in England may well be different to that of Scotland. The former has recognised the principle of inset appointments, and there is judicial authority in *Albion Water*, not merely for access to water transmission but also in respect of fair pricing. In my view, the current legal position is clear, that any refusal to grant common carriage would prima facie be an abuse of a dominant position.

32. Finally, I turn to the position if the law were to be changed. This is very difficult as the question blends law and policies. However, after some anxiety, I do not share the view that Parliament is disabled from legislating a water regime which would preclude common carriage. Indeed, I should be surprised if common carriage were the norm in any or many other member state

33. On the economic evidence from OXERA, which shows that retailer access to lower cost water supplies, (usually) by common carriage, would have significant impact on the current incidence of prices, and possibly very adverse effects on the economics of some water companies if their customer bases were to be eroded, a powerful case could be advanced in support of the application of the qualification within Article 106(2). That is, that the application of a rule which prevented common carriage would "not obstruct the performance in law or in fact of the particular tasks assigned..." but would be required to maintain low cost supplies to significant sections of the population. Any challenge to any new statutory regime, that is, one which extracted the benefits of lower input costs but translated them into lower average water costs, would be a challenge to a policy decision as to how water was to be supplied in England. In my view, even within Article 106(2), the courts would be reluctant to trespass here.

34. It is true that each water company has lived with the possibility, if not the reality, of common carriage for many years and has discharged its functions

appropriately. The new regime would redefine the nature of the "tasks assigned", as member states are entitled to do, so a defence lies to any charge under Article 106(1).

35. Finally, there is a range of considerations which requite attention generally. The logic of allowing entry into retail is that a national customer, for example, a supermarket chain, might require one retailer to supply all its needs for water. A simple model would involve the retailer entrant engaging in agreements with each local incumbent and supplying the supermarket's needs in a single bill which would capture whatever retail economies were available. These might be downstream efficiencies in billing, invoicing and perhaps advice on local water capture and measurement. A more complicated model would involve the retailer searching out and exploiting opportunities upstream for economies in water cost. An example might be identifying a lower cost bore hole outside an incumbent's appointed area from which supply could be made directly or indirectly to the supermarkets. If supply is to be made indirectly this will require a contract for common carriage using the incumbent appointee's pipes. The terms of this common carriage will therefore be vital is assessing the economics of new entry and the economic position of the incumbent appointee.

36. If lower cost water is available, this may involve lower costs for the customer though the former supply from the incumbent appointee would cease. Water revenue would therefore be transferred to the new entrant. An element of the cost to the customer levied by the incumbent appointee would be in respect of common carriage. That cost would be derived from an average of all the incumbent's carriage costs; and its water costs would typically be set at an average cost for the all of the water supplied within the area. If the charge for common carriage does not reflect the average cost of common carriage within the area, and there is no reason why it should, the shortfall in allowed revenue will have to be made up from the remaining customer base. Even if

common carriage charges are based on long run incremental cost a shortfall will still exist if these costs are below average cost. It follows that the incidence of entry will affect the incidence of water charges with some consumers paying more for their water supplies.

37. The difficulty with this scenario is that lower upstream costs may not translate into lower water prices for all consumers, and if charges are de-averaged on any scale, the burden on a diminishing number of typically smaller water users will be correspondingly greater. This appears to be the logic of the current proposals.

38. If a common carriage charging structure precisely compensates for the loss of contribution to fixed and common costs, the revenue impact will be neutralised. Alternatively, following *Cave*, it would be possible for water procurement to be effected by an independent body and water resold to the incumbent appointee to be resold at an average price to customers. The attraction of this latter proposal is that it offers incentives to utilise water distribution more efficiently and for resilience to be encouraged.

39. The underlying problem however is that if de-averaging takes place on any scale as a result of competition, as charges fall more into line with costs this will introduce an element of instability into the water regime, with the pronounced income effects as reported by WICS' economic advisers. It is hard to see how the Water Bill copes with these implications: there is a distinct lack of clarity. One solution would be avoid this challenge by simply prohibiting common carriage and seeking to invoke Article 106, as described above, but given the experience and thrust of policy since privatisation, this looks unlikely.

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