Competition and the water sector

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A debate has developed in recent years in several Member States (including the UK, France, Germany and Portugal) and in the European Parliament on how best to organise the water sector and introduce more transparency and competition. The European Commission should have a voice in such a discussion given that EC competition and internal market rules have an important impact on the water sector. This article looks at the reasons for the growing interest in the water sector, the obstacles to competition, and what the EC rules can do to address these problems.

Interest in the water sector

The water sector has attracted attention recently for both economic and competition reasons.

From an economic point of view water is an important sector of the economy where there are growing competitive pressures. First, the water sector is reported to have an annual turnover in the EU of about € 80 billion, which is more than the turnover of the gas sector. Secondly, the Water Framework Directive adopted in 2000 introduced economic concepts into the environmental legislation by requiring Member States to produce economic analyses of water use from 2004 and to introduce the principle of full cost recovery from 2010. Thirdly, higher environmental standards have increased the cost of water services, and this is likely to continue as existing rules enter into force and standards are increased. Fourthly, infrastructure will require significant investments, particularly in the new Member States, which are likely to come largely from the private sector given the pressures on public expenditure.

From a competition point of view our attention has also been drawn to the water sector. First, an increasing number of antitrust, State aid and merger cases in the water sector have been brought to our attention. Secondly, horizontal issues such as Services of General Economic Interest (SGEIs) and public procurement rules, including on Public Private Partnerships (PPPs), have been widely discussed and have direct implications for the water sector. Thirdly, other organisations, such as the OECD, have taken an interest in the water sector.

DG Competition commissioned an independent study into competition in the water sector in the EU and the final report is available on DG Competition's website. Since then more information has been gathered via the Member States, operators and consumers. In 2003 the Commission Communication on Internal Market Strategy Priorities 2003-2006 announced that the Commission services would look into the water sector and could publish a Working Paper in 2004, and this was repeated in the White Paper on Services of General Interest of May 2004.

Structure of the water sector

From a competition point of view, the most important characteristics of the water sector are:

— water distribution (ie the local transport of water to the final customer) and waste water collection (ie the local collection of waste water from the final customer) are normally natural monopolies at least for domestic customers;

— the fixed costs linked to water distribution and waste water collection represent up to 70 percent of the total supply costs for domestic customers, and this is largely a sunk cost;

— water is difficult and expensive to transport, with transport costs per 100km representing about 50 percent of the wholesale cost of water (compared to 5 percent for electricity and 2.5 percent for gas);

— water and waste water operators are almost always vertically integrated, although there is a growing use of public private partnerships (PPPs) which might change this;

— given the health and environmental needs for high standards in the water sector, national, regional and local authorities have traditionally imposed public service obligations on water operators and granted them exclusive rights as compensation;

— water is provided under the control of local authorities in almost all countries (the UK is an exception) which often only cover a relatively small area.

Two conclusions can be drawn immediately. First, liberalisation of the water sector would be unlikely
to result in the same benefits as in other network industries because a large proportion of the cost of supply of residential customers is incurred by the distribution network (which would remain a monopoly) and there is little scope for supply from distant sources. Secondly, third party access (TPA) to the network — which was used to introduce competition in other network industries — raises concerns about quality standards and liability if these standards are not met. As the health and environmental consequences of unsafe water and waste water can be very serious, the adoption of general rules on TPA would be controversial. The issue of TPA should therefore be examined case by case. Nevertheless it will be interesting to follow market developments in England and Wales which have introduced compulsory TPA to the water networks for the supply of industrial customers following the adoption of the Water Act 2003.

**Competition problems in the water sector in the EU**

**Wholesale markets, in particular supply to commercial consumers**

Although water distribution and waste water collection for domestic purposes are generally considered to be natural monopolies, the supply of water and waste water services is not. For example, large water consumers could in theory be supplied (a) by the local operator; (b) by a neighbouring operator (either via specific pipeline for the site or via third party access to an existing pipeline); (c) through self-supply of water (eg water abstraction rights for raw water from a river or aquifer and possibly own treatment of this raw water); or (d) by a neighbouring water consumer carrying out its own water services (see c above) and with spare capacity.

The question is therefore whether there are legal obstacles to competition. The main threat to competition at the wholesale market, including supply to industrial and commercial consumers, seem to be **anti-competitive state measures** (ie state and local measures which cannot be justified by Article 86(2)). Examples include exclusive rights whose scope or duration is greater than justified; national legislation that permits water operators to share markets (eg Germany seems to allow agreements not to poach customers from each other); and a discriminatory allocation of water abstraction rights, often for indefinite periods.

In addition, **vertical restrictions** arising from exclusive long term supply dealings may be harmful. Examples could include long-term exclusive contracts between an independent treatment plant (possibly constructed under a PPP) and a water operator. **Horizontal restrictions** between operators may also be harmful and contrary to EC law even where national law allows them.

**Market for the supply to households**

Unlike the market for supply to industrial consumers where the quantities can be large enough to justify constructing new pipes, direct water to water competition in the household market would require third party access to the networks and so is unlikely to develop significantly in the near future. The main competitive pressure for domestic consumers therefore comes from competition for the market (ie competition to operate a local monopoly). The main barriers to competition in this market seem to be the lack of transparency when services are provided in-house by the owner of the network (normally the local authority) and problems with public tendering when the owner outsources the exclusive right to operate the network.

**Water is subject to national and EC competition rules**

The EC competition rules apply to all undertakings where there is an effect on trade between Member States.

The ECJ has consistently held that the concept of undertaking covers any entity engaged in an economic activity, and any activity consisting of offering goods and services on a given market is an economic activity. On this basis it seems that the provision of water and waste water services would be considered to be an economic activity, except possibly for domestic consumers in Ireland where the local authorities pay for water through taxation. This is despite recital 1 of the Water Framework Directive which states ‘water is not a commercial product like any other but, rather, a heritage which must be protected, defended and treated as such’, as this refers to water in nature rather than to the provision of water services.

There can be an effect on trade in the water sector (a) if the water consumer is sited close to a border and so could be supplied from a neighbouring Member State, (b) if the water consumer uses the water services as an input into goods that are then traded, (c) where the water operator is dominant on a substantial part of the European Community (eg
supplies large cities or regions), (d) when there is a cumulative effect from a number of smaller networks, or (e) when a contract or concession is outsourced and an operator in another Member State might be interested in it. Normally if there is no effect on trade and the EC competition rules do not apply then the national competition rules will apply.

It is common for water operators to be entrusted by the relevant authority with public service obligations (eg universal service) and to receive in compensation exclusive rights, which remove them from the scope of the competition rules. But in accordance with Article 86(2), the exclusive rights must be proportionate to the service of general economic interest.

Application of the competition rules can help to address these problems

As noted above, liberalisation is probably not the best approach at this stage, but it is possible to encourage transparency and competition within the current structure of the market. This is in line with the views of the European Parliament which called in its resolution on the Green Paper on Services of General Interest for modernisation not liberalisation of the water sector. To encourage competition two important issues must be addressed.

The first is to limit the scope and duration of the exclusive rights granted to local monopolies to the minimum necessary to allow them to provide the public service obligations with which they are entrusted. The application of the competition rules, and in particular Article 86, is essential to achieve this. As public service obligations generally only cover domestic and not industrial purposes, the same should apply to the scope of any special or exclusive rights (see Corbeau (Case C-320/91)). So industrial users should be allowed to choose the most economically advantageous water and waste water services. Similarly, the exclusive right should not cover ancillary services (eg laying pipes or reading meters) which could be done by third parties without compromising the economic equilibrium of the provision of the service of general economic interest. When an exclusive right is granted linked to a specific investment (eg the construction of a treatment plant) its duration should also be limited to the minimum necessary not to compromise the economic equilibrium of the project.

The second is to ensure that there is a competitive market whenever an authority decides to outsource water activities. The competition rules could have a role to play here but this is primarily a question of the application of the public procurement directives and the related rules coming directly from the EC Treaty (eg non-discrimination, equal treatment, transparency). There is also a need for greater clarity of the term ‘outsourcing’, and the ECJ is examining the line between outsourcing and in-house contracts in three pending cases. More transparency in the market (eg via benchmarking) could also help competition.

Conclusion

Even if ‘liberalisation’ does not seem to be appropriate in the water sector at this stage, there is scope to improve competition and transparency in the sector. The most important issues to address to improve competition in the sector are first to reduce the exclusive rights, which are widespread in the sector, to the minimum necessary and secondly to improve the functioning of the outsourcing market. Both issues will be addressed in the Working Paper foreseen in the Internal Market Strategy and the White Paper on Services of General Interest, and could also be addressed by competition or internal market cases if appropriate.