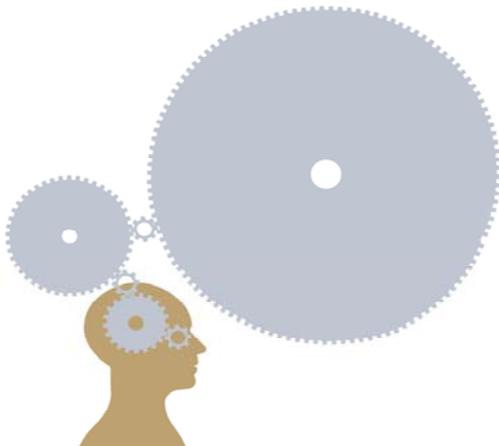


Competition in the water sector in England and Wales

Prepared for ECARES

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Overview

- current regulatory regime
- competition so far
- review of competition
- implications for mergers rules
- other interesting questions for further research

Ofwat current regulatory regime

A 'tweaked' RPI – X system

RPI – X with reviews every 5 years

Quality regulation

- OPA
- GSS
- serviceability indicators

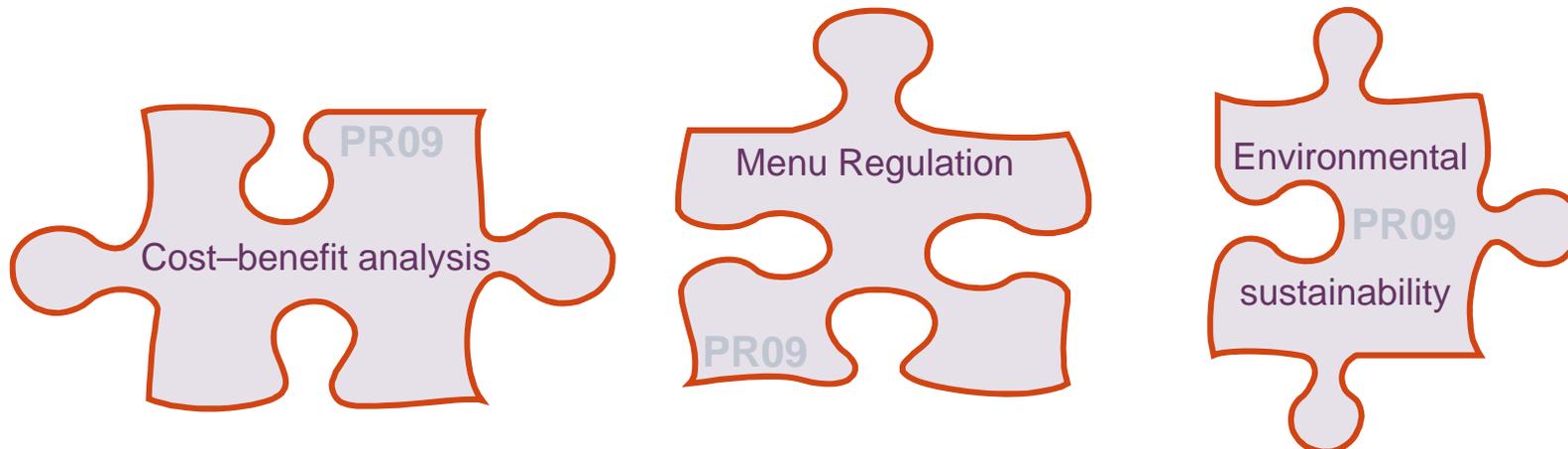
Comparative competition

- econometric models
- cost base
- qualitative comparisons

Risk reduction devices

- interim determinations
- logging up/down

How do they fit?



Competition so far

- attempts to promote competition in the market, through the Water Supply Licensing (WSL) regime, have failed
 - 'No customers have yet switched supplier, few wholesale master agreements (WMAs) have been signed between licensees and appointed water companies, most WMA negotiations are taking too long to complete, and not even half of licensees appear to be actively engaging in WSL negotiations'¹
- various forms of indirect competition have had relative success
 - comparative competition
 - capital market competition
 - contracting out competition
 - self lay
 - inset appointments

¹ Ofwat (2007), 'Outcomes of Ofwat's internal review of market competition in the water sector', April.

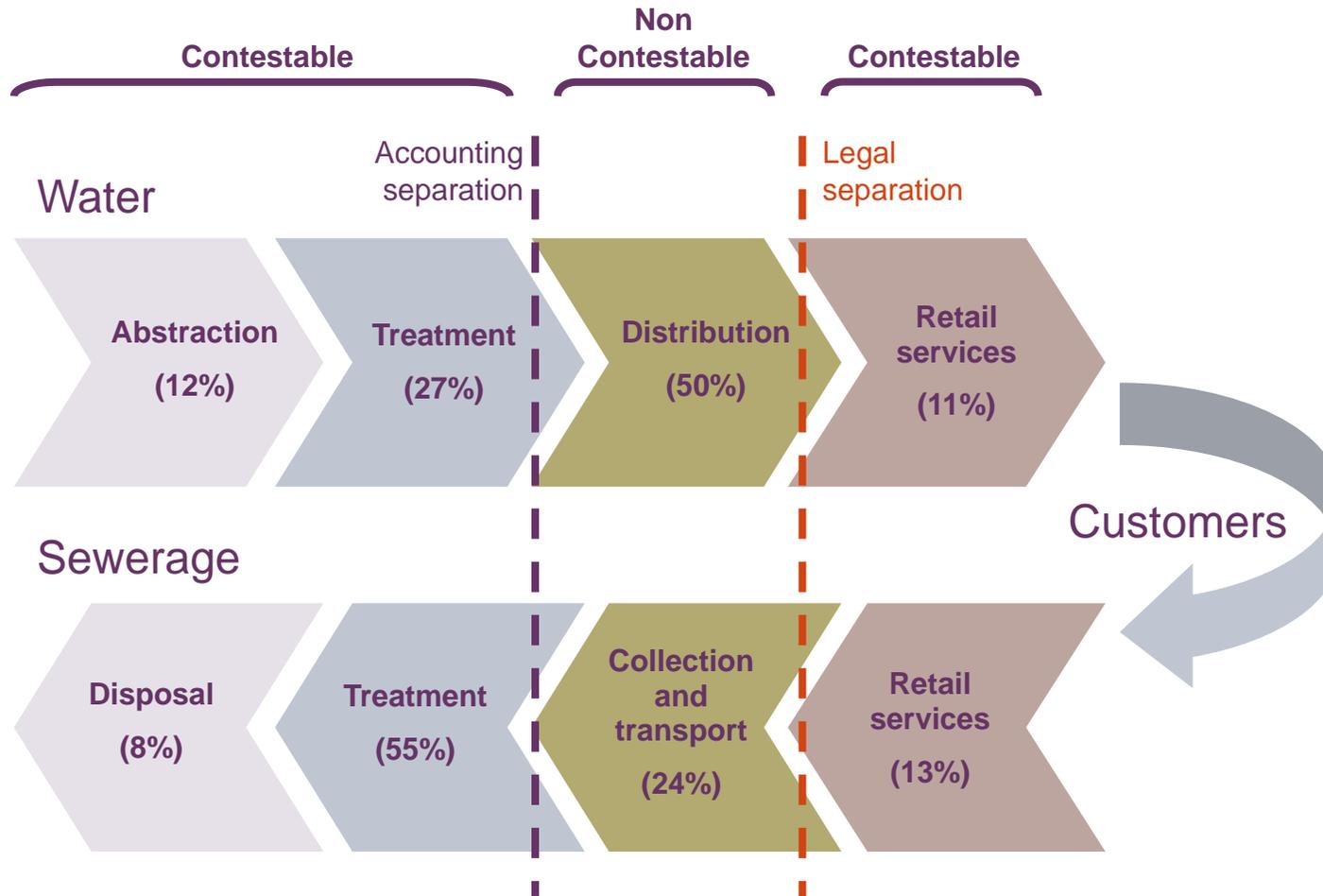
Reasons for WSL failure

- barriers to water abstraction rights trading
 - eg, Environment Agency has discretion to reduce the size of the abstraction rights at the point of the trade
- restrictive eligibility threshold
 - non-households who are likely to be supplied more than 50 megalitres of water per annum (only c. 2,200 consumers)
- application of a 'retail-minus' cost principle
 - wholesale charges equal to the retail charge minus incumbent's avoidable costs

Ofwat's proposed reforms

- vertical separation of contestable elements of the value chain from natural monopoly elements
- implementation of separated price controls across the different parts of the value chain
- replacement of the 'retail-minus' cost principle by a set of general criteria for access pricing
- new retail market arrangements for water, including a gradual reduction of the eligibility threshold up to zero and the subsequent introduction of households in the retail market
- new retail market arrangements for sewerage
- new water abstraction and treatment market architecture, including an effective water abstraction rights trading market
- new sewerage treatment and disposal market architecture

Vertical separation



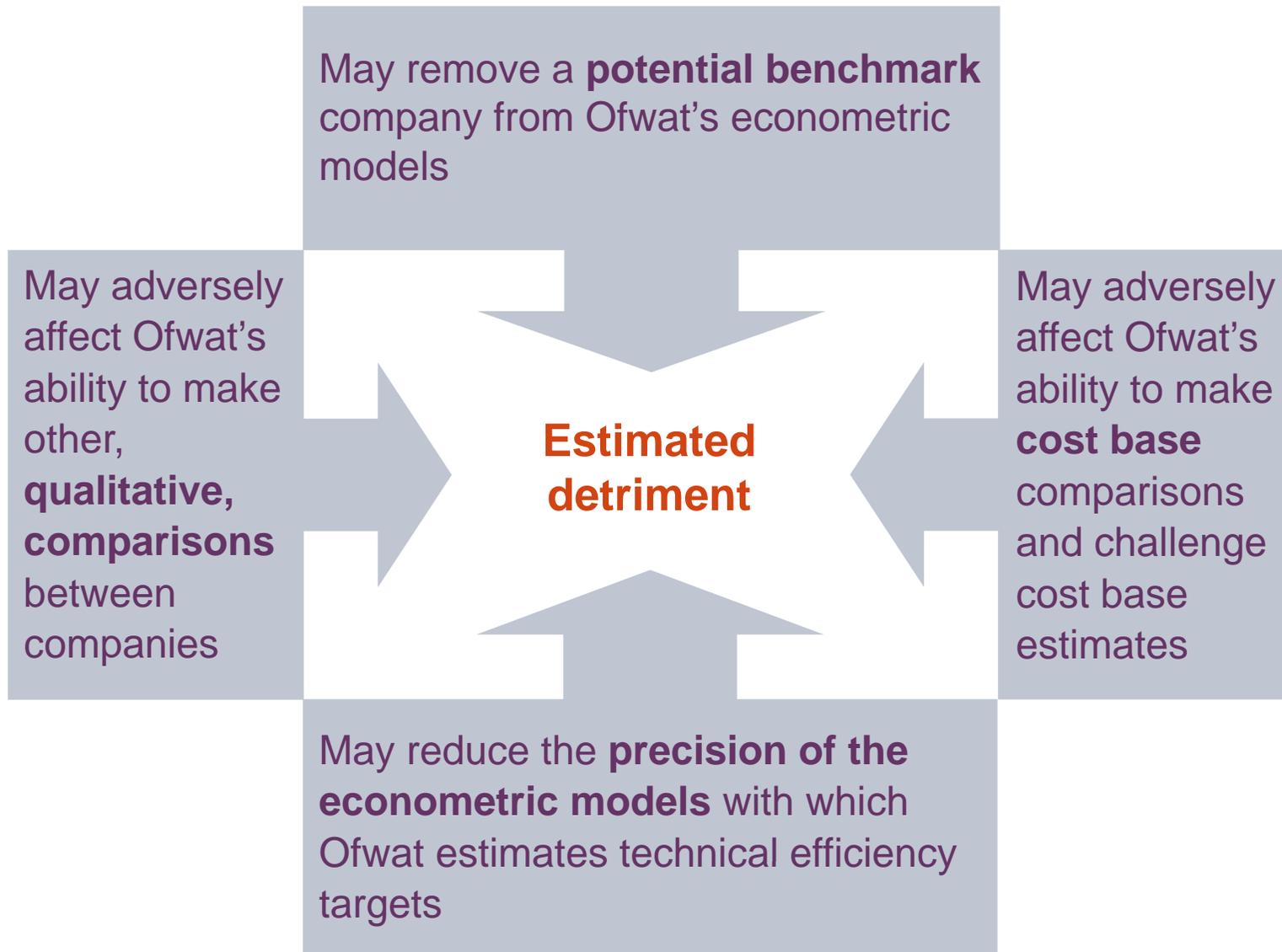
Note: % correspond to indicative industry cost allocations and add up to 100% in each industry.

Source: Ofwat (2008), 'Ofwat's review of competition in the water and sewerage industries: Part II'. And Oxera modifications.

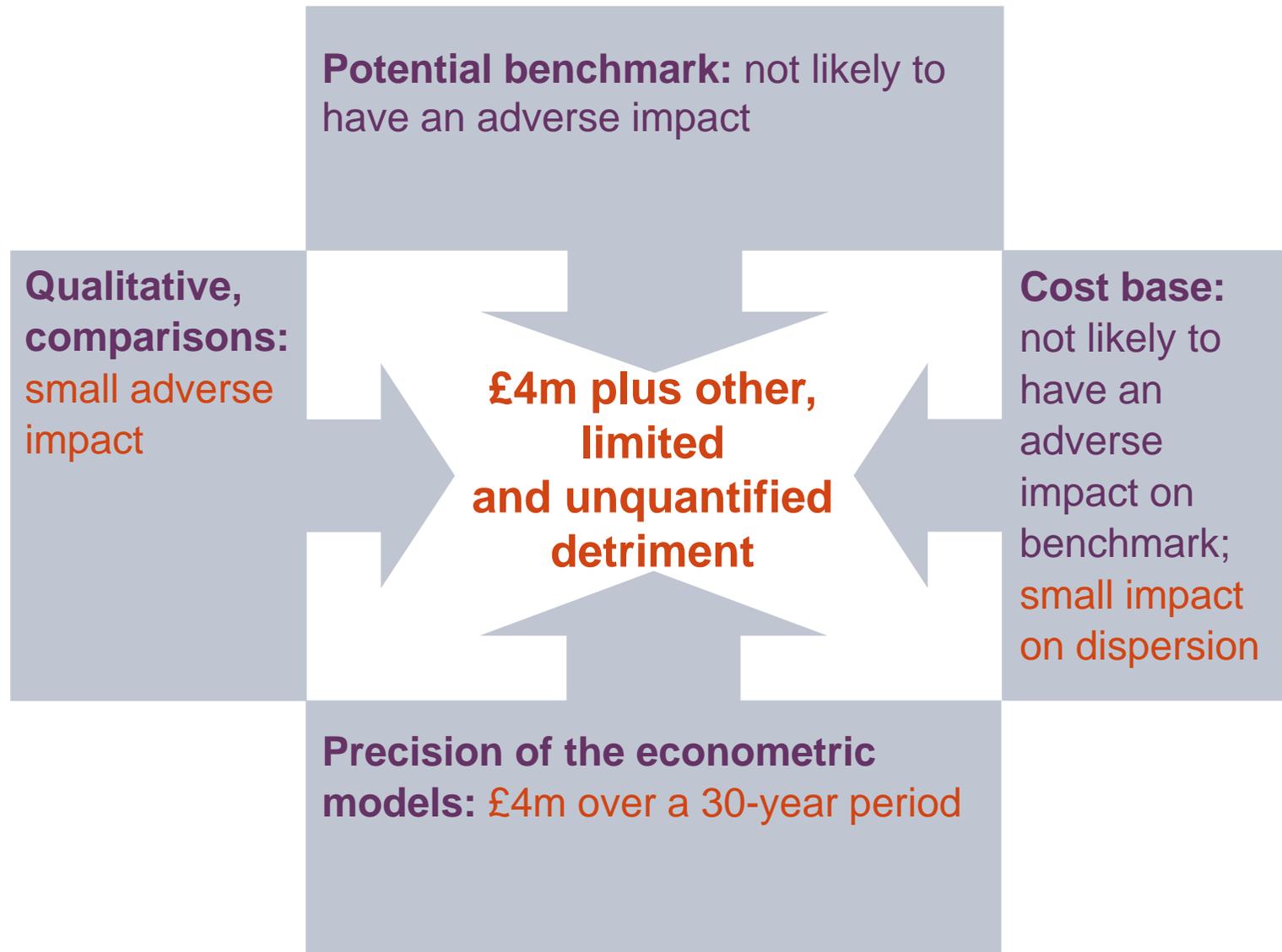
Cave review early thoughts

- remit
 - to consider the scope to deliver benefits and drive innovation through developing competition and contestability
- early thoughts
 - there is scope for competition to deliver these benefits
- caveats
 - little international experience
 - Scotland and Australia are too new
 - step by step approach would be required
 - whole process could take 20 years
 - transitional stages might be needed
 - eg, 'single buyer' model before full-blown 'common carriage'

Impacts of a water merger



South East Water & Mid-Kent Water merger (2007)



Previous merger cases

Case	Remedy
SEW & MKW (2007)	£4m one-off payment £3.1m synergy savings taken into account in PR09
Vivendi (2002)	Divestment
MKW (1997)	Prohibited
SWW & WSX (1996)	Prohibited
SWW & SVT (1996)	Prohibited
Northumbrian (1995)	15% price reduction

Modelling approaches to comparative efficiency

- OLS regression
- corrected OLS regression
- sub-company models using pooled OLS
- non-parametric/semi-parametric modelling
- stochastic frontier analysis (SFA)
- data envelopment analysis (DEA)
- techniques using panel data

How would competition affect merger rules?



The introduction of competition could lead to more consolidation, but only in the contestable parts of the value chain

Questions for further research

- how can the regulatory asset base be split?
- how can we know ex ante which parts of the value chain are contestable?
- will an abstraction rights trading market reveal the true value of water in the context of external costs?
- can a new model of competition drive restructuring in the market? If so, what types of restructuring?

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