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July 2018

Ofwat's New Licence Condition on Undue Conduct – a Quicker Route to Enforcement?

On 16 July 2018 Ofwat published a formal consultation under section 13 of the Water Industry Act 1991 (WIA) to modify the licence conditions of 17 water companies to include new market conduct-related obligations.

The two modifications proposed by Ofwat are obligations that the appointed water company will not:

- show undue preference towards, or undue discrimination against, any person (including itself) in relation to the provision of certain water and sewerage services:
  - the relevant services include: the provision, management or development of water resources; demand management; leakage services; installation or modification of sewers, drains, service pipes and mains (i.e. the self-lay market); supply of water and the supply of sewerage services (i.e. the NAV market); and bioresource activities;
  - the potential third parties that will benefit from this protection include other undertakers, new appointees (NAVs), water supply and sewage licensees, self lay operators, and any other third parties involved in the provision of the listed services.
- disclose, use, or disseminate protected information within the appointed business (subject to legal requirement-type exceptions). In this scenario protected information is any information that the appointed business receives from third parties in connection with:
  - bids for the provision, management, or development of: water resources; demand management; leakage services; and bioresource activities; and

- enquiries about the adoption of water mains or sewerage infrastructure – i.e. new developments and self lay enquiries.

Ofwat's aim in making these modifications is that as new wholesale markets for water resources, demand management, leakage services, and bioresources are opened up to competition, the development of those markets should not be hindered by water companies showing undue preference or discrimination towards themselves or other market participants. Equally, a level playing field is just as important in existing markets, such as the supply of water by NAVs where undue preference or discrimination could be used by vertically integrated monopolies to prevent or harm effective competition by disadvantaging competitors in downstream markets. Ofwat states that it believes that "*the proposed licence modification will be an effective tool for changing company behaviour and signal that water companies are willing to facilitate and participate in these markets*".

Similarly, the restriction on the use of information is intended to support and complement the behavioural condition by preventing internal disclosures of information that might give the water company an unfair commercial advantage and deter competitors, thereby having a dampening effect on competition.

The presentation of these changes in Ofwat's consultation is relatively benign. Reference is made to the existence of a similar obligation in Condition R of the licence that requires the water companies to not show undue preference or discrimination towards water supply and/or sewerage licensees (WSSLs) which was introduced in the context of establishing the business retail market. Undoubtedly, for most water companies used to abiding by the standards of conduct expected of a monopolist with a dominant market position, the obligation not to distort competition through discriminatory behaviour will also feel very familiar and may just appear to be a restatement of the current expectations for future behaviour.

It is striking, however, that there is not one single reference in the entire consultation to Ofwat's existing powers to enforce against this type of conduct under the Competition Act 1998 (CA '98). The CA '98 enables Ofwat to investigate and sanction anticompetitive conduct by water companies, including discriminatory conduct of the type envisaged by the new licence condition. This means that Ofwat already has tools to tackle anticompetitive conduct that hampers the development of existing and new markets.

The introduction of the new licence condition would enable Ofwat to bypass the need to initiate a CA '98 investigation. Instead, Ofwat could simply proceed against the company for a breach of its licence conditions. The significance of this becomes clear when you compare the procedures and burden of proof required to establish a CA '98 infringement compared to the equivalent requirements for enforcing against a breach of a licence condition.

To successfully bring an enforcement action under the CA '98 Ofwat would need to demonstrate that the relevant legal and economic tests are met. This includes establishing the scope of the relevant market, showing that the company is in a dominant position within that market, and demonstrating that it has engaged in abusive conduct that is not capable of objective justification. The abusive conduct will be based upon an economics-based theory of harm that is focused on behaviour which has anticompetitive effects on the market, not just on competitors. The procedural side would involve an investigation by Ofwat, that can typically take months if not years, during which the company's rights of defence would entitle it to make representations on the substance of the allegations and potentially negotiate resolution through commitments. If Ofwat reached an infringement decision, the substantive issues could be challenged by appeal to the Competition Appeal Tribunal. Third parties that have suffered loss as a result of the anticompetitive behaviour can claim damages, but this will be subject to a thorough testing of the substantive case either through the regulatory process, or in a standalone civil case.

By contrast, the procedure for enforcing a licence breach is much more streamlined than that which is required to enforce breaches of the CA '98 obligations. The burden of proof to establish the infringement is simplified, the duration of the process is shorter, and the ability of the company to challenge the allegations is reduced.

Under s18 WIA if Ofwat is satisfied that a company is contravening a licence condition, or is likely to do so, it can issue an enforcement order. To be satisfied that the condition is not being complied with Ofwat would simply need to show that a company has acted with undue preference or undue discrimination – as the condition is currently drafted it would not even need to demonstrate that the conduct has had a harmful effect on the relevant entity, let alone the market as a whole.

The enforcement order can require the company to do, or not to do, such things as are specified in the order so as to achieve compliance with the condition. Under s20 WIA Ofwat must give notice of the proposed enforcement order and allow at least 21 days for representations and objections to be made. The notice will need to set out the condition that has been breached, the acts or omissions that constitute the breach, and other relevant facts that justify making the order. Ofwat must consider any representations or objections that are duly made. Ofwat may also impose an unlimited fine under s22A WIA.

Under s21 WIA the validity of an enforcement order can only be challenged if the recipient of the order considers that its making was not within the powers of s18 or the procedural requirements in s20 have not been complied with. In such circumstances the company will have 42 days to make an application to the High Court. If the High Court considers that the interests of the complainant have been substantially prejudiced by a failure to comply with those requirements then it may quash the order. The enforcement order will also create obligations that benefit any person who might be affected by a contravention of the order. For instance, if the order requires a company to behave in a non-discriminatory way towards a particular entity, then any breach of that duty which causes that entity to sustain loss or damage can be the basis of civil proceedings brought by that entity. Similarly, Ofwat would also be able to apply for an injunction, or other appropriate relief, to ensure compliance with the order.

s19 WIA does require Ofwat to consider whether, before making an enforcement order, it is more appropriate to proceed under the CA '98 and if that is the case, then it should not make such an order. The question of appropriateness, however, is effectively left to the discretion of Ofwat and the only route of challenge to Ofwat's exercise of that discretion would be via judicial review. Ofwat's reference to this licence condition as an "*effective tool*" would suggest that it considers that there will be circumstances where it is appropriate for it to proceed with a licence breach case, rather than a CA '98 case. The comparative ease of the licence breach process will undoubtedly encourage complainants to lobby for this route to be followed.

As such, the consequences for companies failing to meet these standards will be more immediate, direct and significant. Importantly, with the need to establish dominance eliminated, these standards of behaviour will then apply even in circumstances where the water companies are no longer dominant in the relevant markets. There may be a case, therefore, for inserting a sunset provision into the new licence condition that could, for instance, trigger a review of the need to retain the condition after a fixed period of time in light of market developments, or once a certain level of competition has been established in the market.

Ofwat has engaged in consultation with the water companies on the proposed modifications and has taken account of feedback received where appropriate. Ofwat has also been vocal about this initiative in speeches. This is, however, the first formal consultation on the subject and it has been launched under the framework set out in s13 WIA. The s13 consultation is a mechanism to enable third parties and interested

stakeholders to express an opinion on proposed licence condition changes in circumstances where the companies consent to the proposed changes. Whilst we understand that many companies have privately indicated that they will accept the modification, that consent has not yet formally been provided. Should any company not give their consent, in order to impose the change on that company Ofwat would need to refer the modifications to the Competition and Markets Authority (CMA). In accordance with the relevant test set out in s14 WIA Ofwat would need to demonstrate to the CMA that there are matters relating to the carrying out of companies' functions that operate, or may be expected to operate, against the public interest and those adverse effects could be remedied or prevented by the proposed modifications to the Licence.

In this situation, given that the CA '98 already imposes similar conduct obligations on the companies, to the extent that they are dominant, it is an interesting question whether or how that public interest test might be met. Long-standing economic policy has established that this is an acceptable standard of conduct for dominant companies, but the enforcement of those standards is subject to satisfaction of complex legal tests and a strong evidentiary burden.

That said, challenging these proposed licence modifications will be a difficult scenario for most companies to contemplate. Being the test case for challenging Ofwat's policy driven modifications at a time when PR19 business plans will be subject to intense, and financially significant, scrutiny is not an attractive proposition.

Given, however, the significant new powers of enforcement that Ofwat will have as a result of this modification, that consent should not be given lightly. At the very least, companies must understand and be aware of the enhanced risks if they engage in potentially discriminatory conduct and be prepared for the consequences.

Author

This GT Alert was prepared by **Lisa Navarro**. Questions about this information can be directed to:

- Lisa Navarro | +44 (0) 203.349.8757 | navarrol@gtlaw.com
- Or your Greenberg Traurig attorney