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## Competition Act 1998

### Decision of the Director General of Water Services No. CA98/02/2004

#### Southern Water Services Limited/Provision of new infrastructure in East Kent

**3 August 2004**  
(Case CA98/02/17)

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## SUMMARY

The Director General of Water Services (“the Director”) received a complaint under the Competition Act 1998 (“the CA98”) from Mid Kent Water plc (“Mid Kent Water”) against Southern Water Services Limited (“Southern Water”). Both companies are statutory water undertakers under the Water Industry Act 1991. The complaint related to the terms offered by Southern Water to a developer, Rosefarm Estates plc (“Rosefarm”) for the provision of water, wastewater and infrastructure services to a development site, the EuroKent Business Park (“EuroKent”), in Southern Water’s supply area.

Mid Kent Water was competing with Southern Water for the provision of water, wastewater and infrastructure services to developers in Southern Water’s supply area.

Mid Kent Water alleged that Southern Water had breached the prohibition imposed by section 18 of the CA98 (“the Chapter II prohibition”) by making an offer to Rosefarm to provide sufficient capacity to satisfy the entire water demand of EuroKent without making any charge for off-site works. It drew a contrast with Southern Water’s position in earlier correspondence with Rosefarm, in which Southern Water had stated that the cost of works to supply the site could be between £100,000 and £500,000, depending on the amount of water required. In particular, Mid Kent Water alleged that Southern Water’s offer was “*effectively predatory pricing*” and appeared to be “*discriminatory*”.

After carrying out an extensive investigation, the Director has decided that Southern Water’s conduct is not caught by the Chapter II prohibition, and therefore there are no grounds for action on his part. In particular, he sees no sufficient reason to doubt that Southern Water’s suggestion in correspondence with Rosefarm, that a dedicated main from its Fleete Reservoir to EuroKent would be necessary, was based on a misunderstanding of what EuroKent’s requirements were likely to be. The Director has also observed that there appears to be no legal basis on which

Southern Water could have then sought, or could now seek, a contribution from Rosefarm towards its off-site work.

Both Southern Water and Mid Kent Water informed Ofwat that there was nothing in a draft of this decision that they regarded as confidential. The Director has therefore decided that it is not necessary to excise any information from this decision in order to comply with the requirements of section 244 of the Enterprise Act 2002 regarding disclosure of information.

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## THE FACTS

### The parties

1. Southern Water Services Limited (“Southern Water”) is a statutory water and sewerage undertaker, appointed under the Water Industry Act 1991 (“the WIA91”). It provides water services across an area of 4,450km<sup>2</sup> and sewerage services across an area of 10,450km<sup>2</sup>. Its geographic area as a water undertaker includes much of Hampshire, West Sussex and parts of Kent. It has 988,400 water customers and 1,749,900 sewerage customers.
2. Mid Kent Water plc (“Mid Kent Water”), the complainant, is a statutory water undertaker, appointed under the WIA91. It provides water services across an area of 2,050km<sup>2</sup>. Its geographic area includes much of Kent and part of East Sussex. It has 238,500 water customers.

The EuroKent Business Park site (“EuroKent”) is being developed by Rosefarm Estates plc (“Rosefarm”). EuroKent is located on the outskirts of Ramsgate on the Isle of Thanet in Kent, to the east of the A256, just south of Westwood. It is in an area for which Southern Water is both the water and sewerage undertaker. It has an area of 44 hectares for business and commerce use and sports and leisure facilities. EuroKent’s location is shown on the map of the Thanet area at Annex 1.

### Summary of the complaint

3. Mid Kent Water complained to the Office of Water Services (“Ofwat”) in a letter dated 12 November 2002. (The Director General of Water Services (“the Director”) has concurrent powers with the Office of Fair Trading to apply and enforce the provisions of the Competition Act 1998 (“CA98”) with respect to commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services in England and Wales (section 31(3) of the WIA91)<sup>3</sup>.) The complaint related to the terms offered by Southern Water, in a letter dated 25 October 2002, to Rosefarm for the provision of water, wastewater and infrastructure services to EuroKent. In that letter, a copy of which was included in the complaint, Southern Water stated that it could provide water supply and wastewater services to EuroKent so that all of Rosefarm’s current, proposed and future development at EuroKent could proceed in accordance with its development timescales. Southern Water proposed immediately to adopt the current water mains within the site. Southern Water went on to say in the letter:

*“As part of our on-going Asset Plan we will be laying, at a cost to Southern Water, a strategic water supply main from the Fleete reservoir to the Rumfields Tower. This will provide sufficient capacity to satisfy the demands of the entire EuroKent Business Park Development.*

*I can confirm that Southern Water will not add the costs of this new main, to the costs of any on-site works which you will require in the future ”*

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<sup>3</sup> CA98 was amended with effect from 1 May 2004 in order to implement EC Regulation 1/2003 into United Kingdom law. Since 1 May 2004 the Director has had the power to apply Articles 81 and 82 of the EC Treaty in addition to the Chapter I and II prohibitions of the CA98. The conduct complained of occurred prior to 1 May 2004 and the Director has therefore not considered the application of Articles 81 or 82 of the EC Treaty.

5. At the time of Mid Kent Water's complaint, Mid Kent Water was competing with Southern Water for the provision of water, wastewater and infrastructure services to developers in Southern Water's supply area.
6. By October 2002 Mid Kent Water had shown its interest in supplying those services to EuroKent. In particular:
  - (a) it had in January and May 2002 been selected as preferred bidder by Kent County Council to provide water and sewerage services to a number of sites including EuroKent<sup>4</sup>;
  - (b) it had indicated to the Director, in a proposal dated 26 February 2002, that it proposed to seek an inset appointment<sup>5</sup> from the Director in relation to, among other sites, EuroKent, although it had not by the time of its complaint actually submitted an application for such an appointment in relation to EuroKent; and
  - (c) it had planned to construct a new pipeline for potable water supply from Fleete reservoir (owned by Southern Water) to EuroKent and to construct associated pumping and storage facilities. In addition, Mid Kent Water planned to construct a new wastewater pipe to connect EuroKent to Southern Water's foul sewerage system<sup>6</sup>.
7. Mid Kent Water estimated that it would charge Rosefarm Estates £360,000 for the provision of this infrastructure<sup>7</sup>.
8. Mid Kent Water's complaint of 12 November 2002 alleged that Southern Water, by making its offer of 25 October 2002, had abused its dominant position. It claimed that Southern Water's offer of 25 October 2002 was "*effectively predatory pricing*" and appeared to be "*discriminatory*". It drew a contrast between Southern Water's position in the letter of 25 October 2002 and the

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<sup>4</sup> Letter from Mid Kent Water's solicitors to Ofwat of 15 January 2003, paragraph 2.5.

<sup>5</sup> An inset appointment, under section 7 of the WIA91, substitutes another company for the existing undertaker for the provision of water and/or sewerage services for a specific geographic area. A successful inset appointment applicant becomes the statutory undertaker for that specific area.

<sup>6</sup> Letter from Mid Kent Water's solicitors to Ofwat of 15 January 2003, paragraph 2.6. Mid Kent Water proposed to use Southern Water's resources by agreeing a bulk supply of water from, and a sewer connection to, Southern Water's network. Under section 40A(8) of the WIA91 a bulk supply agreement is an agreement between one or more water undertakers for the supply of water in bulk. Under section 40 of the WIA91, the Director can, in certain circumstances, order a water undertaker to give a bulk supply to an inset appointment applicant for such a period and on such terms as the order may specify where both parties cannot reach agreement and where it is necessary and expedient for securing the efficient use of water or the efficient supply of water. Under section 110A(3) of the WIA91, a sewer connection is a connection between a sewer or disposal main and a sewer or disposal main, or a connection which allows a sewer or disposal main to discharge directly into a sewage disposal works. Section 110A of the WIA91 allows the Director by order to require an undertaker to allow the inset applicant to connect to the established undertaker's sewer for such period and on such terms as the order may specify. Ofwat's publication "Inset appointments guidance for applicants" (published February 1999) explains that in practice the applicant and undertaker are expected to have negotiated and attempted to reach agreement on the terms of the bulk supply and/or sewer connection before asking the Director to make an order.

<sup>7</sup> Letter from Mid Kent Water's solicitors to Ofwat of 15 January 2003, paragraph 2.7.

position Southern Water had taken in previous correspondence with Rosefarm, and in particular letters written by Southern Water in September 1998, in which Southern Water had stated that the cost of works to supply water to the site could be between £100,000 and £500,000, depending on the amount of water required, which would need to be paid by Rosefarm.

### **Subsequent investigation by Ofwat**

9. Ofwat wrote to Southern Water on 20 December 2002, summarising Mid Kent Water's complaint and requesting Southern Water's comments as a matter of urgency and in any event before a meeting between Ofwat and Southern Water arranged for 9 January 2003. Ofwat said that it was considering whether to make an interim measures direction under section 35 of the CA98. On 7 January 2003, Ofwat sent Southern Water a list of questions to be discussed at that meeting. At the meeting, Southern Water agreed to provide copies of relevant correspondence between it and Rosefarm up to the end of 1999; in an e-mail the next day (10 January 2003) Ofwat asked in addition for copies of similar correspondence to date.
10. By a solicitors' letter dated 15 January 2003, Mid Kent Water made a formal request to Ofwat for interim measures directions under section 35 of the CA98. Mid Kent Water submitted that Southern Water's actions "*made Mid Kent Water extremely unattractive in financial terms as a potential supplier of potable water and wastewater services to Rosefarm*". Mid Kent Water repeated its view that Southern Water had infringed the CA98 by "*discriminatory and/or predatory pricing*" and again referred to correspondence in which Southern Water had previously stated it would charge Rosefarm for infrastructure improvement works, whereas in the letter of 25 October 2002 Southern Water undertook to carry out infrastructure works at no cost to Rosefarm.
11. On 20 January 2003, the Director decided to open an investigation under section 25 of the CA98, into the following issues, namely whether Southern Water had, by making its offer of 25 October 2002:
  - discriminated in the amounts that it charges customers for mains connections work, with the intention of excluding new entry into its area of appointment by potential competitors;
  - engaged in exclusionary behaviour with the intention of preventing Mid Kent Water from becoming a water undertaker in Southern Water's current area of appointment; or
  - engaged in predatory behaviour by agreeing to undertake capital works at a cost that would not reflect the costs reasonably incurred by Southern Water in providing the works.
12. Ofwat replied to Mid Kent Water's solicitors' letter dated 15 January 2003 by a letter of 30 January 2003, in which, among other things, Ofwat:
  - (a) requested clarification as to whether Mid Kent Water's complaint related to Southern Water's offer only in relation to water supply to EuroKent or also included its conduct in relation to sewerage services; and

- (b) raised a number of questions concerning Mid Kent Water's submission that it would suffer irreparable damage if interim measures were not imposed.
13. Mid Kent Water's solicitors replied to that letter on 5 February 2003. In that letter Mid Kent Water, among other things:
- (a) responded to the question as to whether its complaint included sewerage services by stating that its interpretation of Southern Water's letter of 25 October 2002 was that it covered both water and wastewater services; and
- (b) made further submissions on the question of irreparable damage.
14. On the same date, 5 February 2003, Southern Water provided a detailed reply to the questions raised by Ofwat on 7 and 10 January 2003 and at the meeting on 9 January 2003.
15. On 13 February 2003 Ofwat sent Southern Water a notice under section 26 of the CA98, together with a covering letter. That notice stated that the Director had reasonable grounds for suspecting that Southern Water had infringed the Chapter II prohibition by offering to supply EuroKent with water at no cost, when it had previously stated that off-site works would be required to supply EuroKent which would have to be paid for by the developer. It required Southern Water to provide Ofwat with:
- "copies of all documents including, without limitation, internal documents, notes of meetings (including board meetings), e-mails, notes of telephone conversations, correspondence and reports (including costs estimates) produced by, commissioned by, or at any time in the possession of the Southern Group which relate or may relate, directly or indirectly to:*
- 1) The provision of services (including water supplies and/or wastewater services) to the EuroKent Business Park (which may include, without limitation, on-site and off-site works and work to reinforce existing network(s)).*
  - 2) Southern Water's decision, and subsequent programme of works, to lay a new strategic trunk main from Fleete Reservoir to Rumfields Tower.*
  - 3) Southern Water's interest in, and decisions relating to, tendering for work in response to OJEC Notices 2001/S 63-043431 on 21 March 2001 and 2001/S 100-068715 on 21 May 2001, issued by Kent County Council on behalf of the East Kent Spatial Development Company.*
  - 4) The Distribution Zone Study, relating to the Thanet area, referred to in Appendix A of David Stainthorpe's letter of 5 February 2003."*
16. The section 26 notice also required Southern Water to provide information in response to 11 detailed questions arising out of its letter of 5 February 2003.
17. Ofwat's covering letter asked Southern Water for its comments on a non-confidential version of Mid Kent Water's application for interim measures.
18. Southern Water replied to the 13 February 2003 section 26 notice and covering letter by a solicitors' letter of 24 February 2003, enclosing 14 files of documents.

19. On 28 February 2003 Ofwat wrote to Mid Kent Water indicating a provisional view, giving reasons, that the interim measures requested by Mid Kent Water would not be appropriate in this case. Following a meeting with Mid Kent Water on 4 March 2003, Ofwat sent a letter on 12 March 2003 to Mid Kent Water confirming the Director's decision on Mid Kent Water's request, that is to say that, having considered the information and comments provided by Mid Kent Water, Southern Water and other relevant parties, the Director decided not to make any directions under section 35 of CA98. By a letter of 17 March 2003, Mid Kent Water accepted the Director's reasons for not making interim measures directions.
20. Ofwat continued the investigation into the substantive complaint under the CA98. After consideration of the large volume of material provided by Southern Water on 24 February 2003, on 22 July 2003 Ofwat served a further notice under section 26 of the CA98, requiring the provision of information in response to six questions arising out of that material.
21. That section 26 notice was answered by a letter from Southern Water's solicitors of 19 August 2003.
22. Copies of a draft of this decision were sent to Southern Water on 7 April 2004 and to Mid Kent Water on 23 April 2004. By an email of 7 May 2004, Southern Water confirmed that the factual account in the draft was correct and made a minor drafting comment. By a letter of 28 May 2004, Mid Kent Water asked the Director to reconsider his draft conclusion that Southern Water's conduct was not caught by the Chapter II prohibition of the CA98 and provided comments and information that the Director has carefully considered in reaching this decision. It also informed Ofwat that it had not previously been aware of the account set out in paragraphs 23 to 42 below.

### **The background to Southern Water's decision to invest in a new Fleete-Westwood trunk main**

23. In its letters to Ofwat and responses to the two section 26 notices served upon it, Southern Water has provided a detailed explanation of its investment decision. That explanation is supported by the large amount of internal documentation supplied to Ofwat in response to the section 26 notices.
24. Southern Water's network consists of water trunk main systems and distribution zones<sup>8</sup>. EuroKent is situated within Southern Water's water trunk main system in Thanet. Annex 1 is a map showing EuroKent and the three distribution zones and key trunk mains in Thanet. The Thanet trunk main system consists of, first, the Fleete service reservoirs<sup>9</sup> which collect water from various sources in the area. Flow is boosted by pumps through a trunk main, built in the 1930s and consisting of two parallel 12 inch cast iron pipes, from the reservoirs to three service reservoirs at nearby Rumfields<sup>10</sup> ("Thanet Trunk Main"); these reservoirs serve an area known as the "Rumfields zone". One of these service reservoirs is

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<sup>8</sup> Appendix A: "Southern Water Thanet Water Supply: Investment", attached to Southern Water's letter of 5 February 2003

<sup>9</sup> Marked "Fleete Reservoir" in Annex 1.

<sup>10</sup> Marked "Rumfields Reservoir" in Annex 1.

located at the top of a water tower (“the Rumfields Tower”). Other parts of the Thanet area are served either by gravity or by a boosted flow from service reservoirs at Fleete (respectively, the “Fleete Gravity zone” and the “Fleete Boosted zone”).

25. Southern Water told Ofwat that the Rumfields Tower and the reservoir on top of it have long been a cause for concern. It commissioned an investigation by consultants in 1993 into the need to improve the Rumfields reservoir site, in particular the Rumfields Tower (built in the 1930s). The investigation found<sup>11</sup> that although extensive repairs had been carried out in 1981 the tower again needed major repairs, concrete chunks were crumbling off and rusting steel reinforcement was visible in many places. Given the poor quality of the concrete and the cover to the reinforcement, and that the tower is on a site close to the sea, it was anticipated that further repairs would be needed regularly. However, in 1993 the consultants were unable to assess the extent to which the Rumfields Tower was able to ensure adequate pressure in the Rumfields zone, due to abnormal demand and supply conditions at that time caused by the 1990-1992 drought. The consultants recommended repair, while raising the possibility that by 2005 the tower would need to be demolished and replaced if by then it had reached the end of its useful life.
26. Southern Water also told Ofwat that in the past few years it has sought to increase its knowledge of the Thanet Trunk Main and distribution networks in order to understand what investment would be needed to meet increasing demands from development in the area and to address the consequences of natural deterioration of its network.
27. The first stage in its analysis was to create hydraulic models of the distribution and trunk main networks. (A hydraulic model of a zone is a mathematical simulation of the hydraulic characteristics of that zone.) Southern Water’s previous hydraulic models of its Thanet network covered the three distribution networks only, not the trunk main. By August 2001, Southern Water had created one Fleete Model covering all of its three Thanet distribution networks and a new Thanet Trunk Main hydraulic model.
28. Once those hydraulic models were complete, it was possible for Southern Water to carry out a Distribution Zone Study to analyse the performance of the distribution networks and to identify areas requiring improvements to reach performance targets. The Needs Stage of this study was completed in May 2002. It was found that the Thanet Trunk Main was deteriorating, and that values for headlosses<sup>12</sup> were approaching Southern Water’s “borderline” and “critical” classifications for pipework performance. Any increase in flow through the Thanet Trunk Main would result in higher headlosses and increased pressures, placing the pipes under stress and increasing the risk of bursts.
29. Against that background and the background of its Distribution Zone study and hydraulic models, in July 2002 Southern Water commissioned a further study into water supply in Thanet; and an interim report by BSF Consulting Engineers Ltd (“BSF”) entitled “Thanet Water Supply-Strategy: Interim Report” was completed in

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<sup>11</sup> Southern Projects Ltd, August 1993, “Rumfields WSW improvements”.

<sup>12</sup> Headloss describes the loss of water pressure and velocity as a result of friction with the internal surface of a pipe. The rougher the pipe surface the greater the headloss. Pipe fittings, such as water meters, can also result in headloss.

September 2002. The interim report identified a number of problems in the Thanet area, in particular low pressure in the Rumfields zone. It found that those problems would be aggravated by new development in the Thanet area, particularly in the Rumfields zone<sup>13</sup>. It recommended that a scheme should be prepared for the construction of a new reservoir at Fleete, provision of new boosters at Fleete and a new main from there to Rumfields, and demolition of the existing Rumfields plant (the Rumfields Tower and Reservoirs). It recommended that this be done in three phases: (1) a new main of 500mm diameter from Fleete to Westwood (just north of EuroKent), connected to the Ramsgate booster, with a 250mm connection for EuroKent<sup>14</sup> (this main would initially operate as an addition to, but would ultimately replace, the Thanet Trunk Main; (2) construction of a new reservoir at Fleete, provision of additional boosters and construction of a 450mm diameter main from Westwood to Rumfields; and (3) demolition of the tower and service reservoirs existing structures at Rumfields.

30. A proposal was put to Southern Water's Approvals Committee along the lines of the interim report's recommendations. The Committee met on 31 October 2002 and approved the proposal in outline; proposals for phased implementation were approved on 19 December 2002. Construction of the new Fleete-Westwood trunk main then began.

31. In the second section 26 Notice to Southern Water of 22 July 2003, Ofwat asked Southern Water to explain whether Southern Water's proposed strategic main from the Fleete reservoir to the Rumfields zone was needed at all. In particular, Ofwat noted that a report by Montgomery Watson commissioned by Southern Water and dated 15 January 2003 (which date was after Southern Water's decision to construct the strategic main) suggested that there was no clear case to replace the existing twin mains. The report identifies the hydraulic conditions within the existing mains between Fleete and Rumfields. The Director is satisfied with Southern Water's explanation that the Montgomery Watson report did not address Southern Water's long-term water supply strategy in the Thanet area and that Southern Water had followed the advice produced by the BSF Report, which recommended the replacement. Southern Water presented the proposal to replace the existing mains, based on the report that it commissioned from BSF, to Southern Water's approval committee in outline on 31 October 2002. It was approved on 19 December 2002, and work on phase one began on this date. This approval is included in the minutes of Southern Water's ASA/B group meeting in Volume 4 of Southern Water's 24 February response. The ASA/B group considers and approves or rejects Southern Water's capital projects.

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<sup>13</sup> Southern Water stated in its solicitors' letter of 24 February 2003 that residential developments in Broadstairs posed the greatest threat to maintenance of water supply in the Rumfields zone because they would contribute directly to demand in peak periods.

<sup>14</sup> This proposed connection to EuroKent does not, in the Director's view, affect any issue in this case. Even assuming that the reference means a reference to the EuroKent site (and Southern Water has claimed in its letter of 19 August 2003 that "EuroKent" is often used to refer to the whole area south of Westwood), there is no basis on which Southern Water could charge Rosefarm for that connector, given that there is already a main (the Haine Road main) serving EuroKent with sufficient supplies of water. It appears that the purpose of this connector is to serve EuroKent once the original trunk main is taken out of service.

## The background to Southern Water's earlier correspondence with Rosefarm

32. As has been stated above, Mid Kent Water's complaint about Southern Water's offer to Rosefarm of 25 October 2002 referred to the position Southern Water had taken in previous correspondence with Rosefarm and others, and in particular to a letter from Southern Water to Rosefarm of 16 September 1998, where Southern Water had stated that to supply water to EuroKent would involve expenditure on upgrades to its off-site network of between £100,000 and £500,000 depending on the amount of water required, the cost of which would need to be paid by Rosefarm.
33. In its responses to Ofwat's investigation, Southern Water gave Ofwat a detailed account of the background to that correspondence.
34. On 27 May 1998, Rosefarm's engineers submitted a Water Supply Concept Plan to Southern Water's Water Operations Team ("the Water Operations Team"), to assess the impact of the development of EuroKent on Southern Water's ability to provide supplies to the area. The plan identified the maximum flow to be provided to 33 sites within the EuroKent Plan. The size of a main that is required for any particular locality will normally be determined by the maximum or peak demand for water that customers in that locality are collectively expected to have.
35. In analysing that plan, Southern Water concedes that the Water Operations Team "*erroneously drew the conclusion that the summation of all the potential demands was the peak demand and concluded that the ultimate design demand from the development was 70l/sec*". In a letter dated 16 September 1998 to Rosefarm, Southern Water pointed out that other comparable business developments typically had an average demand of 0.25 litres per second ("l/s") per hectare and peak demand of about 0.5l/s per hectare (which would have suggested that EuroKent would require an average supply of about 11l/s and a peak supply of about 22l/s). But Southern Water still failed to dismiss the figure of 70l/s as implausible.
36. As a result of those errors, the correspondence then proceeded on the (erroneous) basis that EuroKent's likely demand for water supply could be in the region of 70l/s at peak times, and was likely to be over 10l/s at peak times. A demand of the order of 70l/s (over 50% of supply into the Rumfields zone), or indeed of any quantity substantially over 10l/s, would have required the laying of a new dedicated main from the Fleete Reservoir to EuroKent, rather than upgrading the Rumfields zone infrastructure. Had Rosefarm requisitioned such a supply under section 41 of the WIA91, Southern Water would have been able to require payment by Rosefarm in respect of the cost of that new main under section 42, or a one-off payment in lieu. (The provisions of sections 41 and 42 of the WIA91 are explained below, at paragraph 58.) That was the basis of the figure of £500,000 quoted in Southern Water's letter of 16 September 1998 to EuroKent.
37. Southern Water's letter to Rosefarm of 16 September 1998 also refers to an amount of up to £100,000 for supplies of up to 10l/s. Southern Water told Ofwat that its Water Operations Team took the view that supply of up to around 10l/s was available in the Rumfields zone from existing infrastructure<sup>15</sup>. However, the Water Operations Team was concerned that supplies in the order of 10l/s could

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<sup>15</sup> Letter from Southern Water's solicitors dated 24 February 2003 to Elaine Chatham, Ofwat.

lead to a deficiency in the supply system from the Rumfields Reservoir site. The Water Operations Team believed that to reinforce the trunk main and overcome that system deficiency would cost £100,000<sup>16</sup>. Southern Water therefore referred to that amount – and the possibility of seeking a contribution towards it from Rosefarm – in its letter of 16 September 1998. The figure of £100,000 therefore related to different work than the figure of £500,000, which, as explained in paragraph 36 above, related to the cost of laying a dedicated main that was capable of supplying 70l/s from the Fleete Reservoir to EuroKent.

38. In the event, however, EuroKent was connected in 1999 to the Fleete Boosted zone although with a limit on supply of 5.1l/s (adequate at that stage of development).
39. Because of the Water Operations Team's erroneous view that Rosefarm was asking for supply in the order of 70l/s, Southern Water continued in correspondence with Rosefarm and other interested parties (such as the local authorities) to proceed on the basis that Rosefarm would in the course of further development of EuroKent have to requisition a dedicated water main from the Fleete Reservoir under section 41 of the WIA91 and that in order to do so it would have to pay a sum in the order of £500,000 (in lieu of section 42 payments) to Southern Water.
40. However, by the time Rosefarm began, in autumn 2002, to explore with Southern Water the question of supply for further development as set out in its letter of 11 October 2002, Southern Water had improved its understanding of the extent of problems with its Thanet area network and in particular the Rumfields zone and, as explained above, was about to make investments to upgrade its network.
41. The proposals set out in the letter of 25 October 2002 were therefore made on the basis that a new trunk main would be constructed between the Fleete Reservoir and Westwood as phase (1) of the overall plan described above. On the basis of the construction of the new trunk main, its previous concerns as to the potential impact of a supply in the order of 10l/s to EuroKent from the Rumfields zone no longer applied. Southern Water has explained<sup>17</sup> that the new main will allow Southern Water to move some areas, including EuroKent, from the Fleete Boosted zone to the Rumfields zone, known as "re-zoning". Re-zoning can be achieved by opening and closing valves which are often built into zones during their construction to allow operational flexibility (a practice which is commonplace in the water industry).
42. In any event, by that stage Southern Water was no longer proceeding on the (false) basis that the supply needed by EuroKent would be of such a scale that a new dedicated main would need to be constructed from the Fleete reservoir.

## **LEGAL AND ECONOMIC ASSESSMENT**

43. For the reasons set out below, the Director's view is that, on the basis of the material before him, Southern Water has not infringed the Chapter II prohibition of the CA98 in relation to its offer of 25 October 2002, as alleged by Mid Kent Water.

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<sup>16</sup> This was a change of position from Southern Water's initial view expressed in May 1998 that 10l/s was available without major alterations to the distribution system.

<sup>17</sup> Emails from Southern Water to Ofwat dated 12 May 2004 and 9 June 2004.

44. The Chapter II prohibition provides that: “*any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.*” (Section 18(1), CA98)<sup>18</sup>.
45. The Director is satisfied that Southern Water is an undertaking; indeed, that proposition has never been in dispute.
46. In order to establish that an undertaking has infringed the Chapter II prohibition, the Director must show that:
- the undertaking holds a dominant position in a relevant market;
  - the undertaking has abused that dominant position; and that
  - the abuse may affect trade within the United Kingdom or any part of it.
47. Section 60(1) of the CA98 sets out the principle that, so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising in relation to competition within the United Kingdom should be dealt with in a manner which is consistent with the treatment of corresponding questions arising in European Community law in relation to competition within the Community. In particular, under section 60(2) of the CA98, the Director must act (so far as is compatible with the provisions of the CA98) with a view to ensuring that there is no inconsistency with either the principles laid down by the EC Treaty and the European Court<sup>19</sup> or any relevant decision of the European Court. Under section 60(3) of the CA98, the Director must also have regard to any relevant decision or statement of the European Commission.

## **THE RELEVANT MARKET**

48. As the Competition Commission Appeal Tribunal observed in *Aberdeen Journals v. DGFT (No. 1)* [2002] CAT 4, [2002] CompAR 167, paragraph 88:

*“In order to determine whether, in any given case, an undertaking has the necessary degree of economic strength or, to use the more modern term, market power, so as to give rise to dominance, it is self-evidently necessary to define the market in which that market power is said to exist.”*

49. For the purposes of competition law, the relevant market can be said to comprise a relevant product, geographic and temporal market. The product and geographic markets may be defined as follows:

*“a relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use. The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be*

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<sup>18</sup> Under section 18(3) of CA98, “dominant position” means a dominant position within the UK, or any part of it.

<sup>19</sup> The European Court is defined as the Court of Justice of the European Communities and includes the Court of First Instance (section 59(1) of CA98).

*distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas.”*<sup>20</sup>

50. The European Commission has provided guidance on how it applies this concept in practice in its Notice on market definition<sup>21</sup>. The Notice also describes the sorts of information that may be used to define markets. These include product characteristics, evidence of past substitution, differences in prices and price trends, and the views of customers and competitors. Supply-side substitution may also be relevant to a definition of the relevant market where its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy.

### **Product/service market**

51. Mid Kent Water submitted that one relevant product/service market is “*the laying of new mains potable water and wastewater pipes, and the provision of necessary ancillary connection and development works and services*”<sup>22</sup> (the “Infrastructure Market”). Mid Kent Water also submitted that another relevant product/service market is the supply of potable water (“the Supply Market”)<sup>23</sup>.

52. The Director was prepared to accept Mid Kent Water’s submission on the relevant product/service markets as a starting point in his assessment of the relevant product/service market(s) in this decision. In the light of the Director’s conclusions in paragraphs 65 to 74 below, ultimately the Director has not found it necessary to carry out a more detailed analysis of the relevant product/service market(s), nor to reach any concluded view on the product/service market(s).

### **Geographic market**

53. In 1989 the Secretary of State granted instruments of appointment to companies to operate all aspects of public water and sewerage services within defined geographic areas. Section 37 of the WIA91 sets out the general statutory duty of a water undertaker to maintain an efficient and economical system of water supply within its area of appointment.

54. Mid Kent Water submitted that, in the case of each of its suggested relevant product markets, the relevant geographic market for the purpose of its complaint is Southern Water’s statutory supply area<sup>24</sup>.

55. The Director has taken Mid Kent Water’s submission as a starting point in his assessment of the relevant geographic market in this decision. In the light of the Director’s conclusions in paragraphs 65 to 74 below, ultimately the Director has not found it necessary to carry out a more detailed analysis of the relevant geographic market, nor to reach any concluded view on the geographic market.

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<sup>20</sup> Commission Notice on the definition of the relevant market for the purposes of Community competition law (OJ C 372, 3 December 1997, p5). The definitions reflect the case law of the European Court, as set out in that Notice; see also *Aberdeen Journals v. DGFT (No. 1)*, cited above, paragraphs 91-94.

<sup>21</sup> See footnote 20 above.

<sup>22</sup> Letter from Mid Kent Water’s solicitors to Ofwat of 15 January 2003, paragraph 4.3.

<sup>23</sup> *Ibid*, paragraph 4.8.

<sup>24</sup> *Ibid* paragraphs 4.2, 4.6 and 4.10.

## DOMINANCE

56. The European Court of Justice has defined a dominant position as:

*“...a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.”<sup>25</sup>*

### The Infrastructure Market

57. With regard to the Infrastructure Market, Mid Kent Water’s letter to Ofwat of 15 January 2003 states that *“Mid Kent Water estimates that more than 60% of all contestable Services, and 100% of all non-contestable Services, provided in Southern’s licence area are undertaken by Southern.”* Mid Kent Water told Ofwat that it bases these figures on its internal best estimate<sup>26</sup>.

58. Under section 41 of the WIA91, owners or occupiers in a locality, or the local authority, can require the incumbent undertaker to provide a new water main for the purpose of supplying water to any premises in its area. However, sections 41(1)(c) and 42 provide that the incumbent undertaker is under a duty to comply with that requirement only if the person who has required the provision of the main enters into undertakings to pay in each of the 12 years following the provision of the main an amount not exceeding the “relevant deficit” for that year as calculated in accordance with section 43. The incumbent undertaker may also require that person to give reasonable security for those payments. In practice, the incumbent undertaker usually agrees not to require such undertakings or security from the person requiring the main in return for a one-off payment.

59. Alternatively, developers can choose either to install the new main themselves or employ a company (known as a self-lay organisation, or SLO) to do this work. The developers can plan the main laying and connection work to suit their site programme. This provides incentives for SLOs and water undertakers to improve their performance and calculate their charges on a more competitive basis. Water undertakers can compete for this work in both their own and other undertakers’ areas, working to the same requirements as SLOs. Ofwat’s publication “Competition in providing new water mains and service – Guidance to water companies”<sup>27</sup> lists examples of the types of work that are contestable (open to competition) and those that are non-contestable (not open to competition). Contestable work includes installing mains on a development site, and installing mains outside development sites where a SLO has obtained the necessary easements and satisfied any other legal requirements. Non-contestable works include off-site work to reinforce the existing network and approving on-site water system designs.

### The Supply Market

60. On the Supply Market, Mid Kent Water’s letter to Ofwat of 15 January 2003 stated: *“Mid Kent Water estimates that more than 99% of all potable water and more than 98% of all wastewater services provided in Southern’s licence area are*

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<sup>25</sup> Case 27/76: *United Brands v Commission* [1978] ECR 207 paragraph 65.

<sup>26</sup> Letter of 5 February 2003 to Ofwat from Mid Kent Water’s solicitors, page 2.

<sup>27</sup> Published in March 2002.

*undertaken by Southern.*<sup>28</sup> In its response of 5 February 2003 to Ofwat's request for its reasoning and evidence, Mid Kent Water stated that there are "*private water supplies using wells and springs within Southern's region*", which meant that Southern Water did not supply all potable water services in its licence area.

61. If Southern Water did not have a dominant position in the Infrastructure Market, a dominant position in the Supply Market could be relevant. In order to establish an infringement of the Chapter II prohibition, it is in certain circumstances not necessary to show that an abuse was committed in the market which the undertaking dominates. As the Competition Appeal Tribunal has stated<sup>29</sup>, it is well established that an undertaking with "*a dominant position in one market may abuse that position by engaging in predatory conduct on a neighbouring or associated market*".
62. In its response dated 24 February 2003 to Ofwat's first Section 26 Notice<sup>30</sup>, Southern Water states: "*for the purposes of these initial and outline observations, Southern is prepared to concede that it is in a dominant position. Southern, however, expressly reserves its rights to comment in greater detail...at a future date.*" It has not been asked to make, nor has there been any specific reason for it to make, any further comments on this subject up to the time of publication of this decision.
63. In the light of the Director's conclusions in paragraphs 65 to 74 below, ultimately the Director has not found it necessary to reach a concluded view on whether Southern Water holds a dominant position on a relevant market. Nor has he needed to reach a concluded view on whether in the circumstances of this case the Infrastructure Market and Supply Market are "neighbouring or associated markets" or on whether the circumstances are such that the principle set out in paragraph 61 above applies.

## **ABUSE**

### **Reasonable suspicion of abuse**

64. Based on the information provided by Mid Kent Water, in its letters of 12 November 2002 and 15 January 2003, the Director had reasonable grounds to suspect that Southern Water's conduct in offering to supply EuroKent on the terms set out in its letter of 25 October 2002 amounted to an abuse of its putative dominant position. On the basis of the correspondence between Southern Water, Rosefarm and others over the years leading up to 2002, the essence of Mid Kent Water's case was that until October 2002 Southern Water's position had been that it would incur costs of between £100,000 and £500,000 in off-site infrastructure work to supply EuroKent with water if it were to be developed in the way proposed by Rosefarm and that it would require Rosefarm to agree to pay those costs before it would agree to supply EuroKent (see paragraph 58 above for an account of the relevant statutory provisions). Yet in October 2002, against the background of Mid Kent Water's clear interest in supplying EuroKent (see paragraph 6 above), Southern Water's position appeared suddenly to change,

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<sup>28</sup> Paragraph 4.11.

<sup>29</sup> See *Aberdeen Journals Limited v OFT* [2003] CAT 11 at [322].

<sup>30</sup> Letter from Southern Water's solicitors to Elaine Chatham, Ofwat.

and it was able to offer to supply EuroKent with water for all present, proposed and future developments on the site at no charge for off-site infrastructure work. The Director therefore reasonably suspected predatory pricing by Southern Water and/or unlawful discrimination by Southern Water in favour of Rosefarm as compared with other developers; he reasonably suspected that the purpose or effect of the conduct in question was to exclude Mid Kent Water from obtaining the business in question. Given the at least reasonable suspicion that Southern Water held a dominant position (as to which see above), that amounted to reasonable suspicion that Southern Water had abused its dominant position.

### **The Director's reasons for finding no abuse**

65. The Director's view is that, even on the assumption that it holds a dominant position, Southern Water has not abused that position.

66. The Director reaches that view for the following reasons.

67. The first question is whether Southern Water has abused its putative dominant position by not charging Rosefarm £500,000 for the provision of a dedicated water main from the Fleete Reservoir to EuroKent. Having reviewed the documents provided by Southern Water and having considered Southern Water's explanation, the Director sees no sufficient reason to doubt Southern Water's submission that there is no, and has in fact never been any, need to lay a dedicated main from the Fleete Reservoir in order to supply EuroKent with its current or future requirements for water. In particular, he sees no reason to doubt that the suggestion (in Southern Water's letter of 16 September 1998 and subsequent correspondence) that a dedicated main from Fleete to EuroKent would be necessary was based on a misunderstanding of what EuroKent's requirements were likely to be; see paragraphs 35 and 36 above. Since the issue of a dedicated main does not arise, no criticism can be made of Southern Water not insisting on supplying EuroKent by a dedicated main for which Rosefarm would have to pay under section 41(1)(c) and 42 of the WIA91 (or pay an agreed sum in lieu).

68. The next question is whether Southern Water has abused its putative dominant position by offering to arrange for the supply of water to EuroKent without seeking a payment of about £100,000 from Rosefarm towards upgrading the Rumsfield zone network, as originally contemplated in Southern Water's letter of 16 September 1998.

69. It appears from the material seen by the Director that at least the bulk of the supply sought by Rosefarm was for domestic purposes, as defined in section 218 of the WIA91, that is to say, for drinking, cooking, washing, central heating and sanitary purposes<sup>31</sup>. Under sections 45-51 of the WIA91, Southern Water is under a duty to connect a service pipe from its mains to any premises which consist of a building or part of a building or on which a person is proposing to erect a building, provided that the purpose of the connection is to receive a supply of water for domestic purposes. There is nothing in those sections<sup>32</sup>, or

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<sup>31</sup> Supply of water to, say, a pub or cinema will therefore be for domestic purposes as defined in s.218.

<sup>32</sup> Contrast s.55 (3)(a) of the WIA91 which provides, in relation to a supply for non-domestic purposes, that the water undertaker can refuse a supply if it would involve him in "unreasonable expenditure" to carry out works to enable him to meet all his existing and certain probable future obligations to supply water. There is no comparable provision in relation to supply for domestic purposes.

any other part of the WIA91, that permits Southern Water to make that connection conditional on a payment by the person making the request towards upgrading the network<sup>33</sup>. The only direct costs that Southern Water can recover are the expenses that it reasonably incurs in making the connection (section 45(6) of the WIA91), although water undertakers are also entitled to make a general charge for connecting new premises (see paragraph 71 below).

70. The Director therefore observes that there appears to him to be no legal basis on which Southern Water could have sought in 2002 or could now seek the contribution to upgrading the Rumfields zone network referred to in its letter of 16 September 1998, or any basis upon which Southern Water could have sought or could now seek to make supply to EuroKent conditional upon such a contribution being made<sup>34</sup>.
71. Water undertakers are also entitled to recover a charge for the connection to a supply of water of premises which have never previously been connected to a supply of water for domestic purposes (an "Infrastructure Charge") (section 146(2) of the WIA91). Infrastructure Charges are a contribution towards the overall costs of developing local networks to serve new customers and therefore bear no relation to any specific costs of upgrading a network that an undertaker may incur as a result of an individual connection. Condition C of Southern Water's Instrument of Appointment sets out the way in which Infrastructure Charges must be calculated and provides a limit on the amount that Southern Water can charge. Mid Kent Water's complaint did not claim that Southern Water would not levy Infrastructure Charges in relation to the EuroKent site. The Director notes that in the period since Mid Kent Water complained in its letter of 12 November 2002, Southern Water has levied Infrastructure Charges where connections have been made to individual plots on the EuroKent site<sup>35</sup>.
72. The letter of 25 October 2002 therefore did no more than reflect the legal position that Southern Water had no basis upon which to pass on the costs of upgrading the network. Therefore there can be no grounds for an infringement of the Chapter II prohibition of CA98 concerning its failure to do so.
73. Insofar as any of the proposed supply to EuroKent was for non-domestic purposes (as defined by section 218 of the WIA91), the Director notes that as of October 2002 and subsequently, there is no basis upon which Southern Water could have refused a supply under sections 55-56 of the WIA91. Any attempt by Southern Water to rely on section 55(3)(a) (which allows a water undertaker to refuse supply if the consequence of supply would be that it would have to incur unreasonable expenditure in doing work in order to meet all its existing and certain probable future supply obligations) would have been doomed to failure, since Southern Water had by that stage decided to incur the upgrade expenditure in any event, for the reasons already set out in paragraphs 23 to 31 above) and which, having reviewed the extensive internal documentation provided to him, the Director has no reason, or no sufficient reason, to doubt. For the same reason, the Director does not consider that, as part of the terms and conditions of providing a supply for non-domestic purposes under sections 55-56 of the

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<sup>33</sup> Southern Water accepts, in its solicitors' letter of 24 February 2003, paragraph 1.3, that it has no basis for passing on the costs to Rosefarm of upgrading the Rumfields network.

<sup>34</sup> Since there is no need to lay a new main, sections 41-44 of the WIA91 do not apply.

<sup>35</sup> Emails from Southern Water to Ofwat dated 10 February 2004 and 23 February 2004.

WIA91<sup>36</sup>, it would have been reasonable for Southern Water to require a specific contribution towards the work (described in paragraph 29 above) that Southern Water had by that stage decided to carry out in any event.

74. The Director therefore takes the view that there is no basis on which Southern Water can be said, by making the offer of supply to EuroKent on the terms set out in its letter of 25 October 2002, to have abused any dominant position it might hold.

75. Since the Director has found no abuse, the question of effect on trade in the United Kingdom does not arise.

## **CONDITION E OF SOUTHERN WATER'S INSTRUMENT OF APPOINTMENT**

76. Mid Kent Water's complaint also claimed that Southern Water's conduct constituted a breach of condition E of Southern Water's Instrument of Appointment<sup>37</sup>. However, given his conclusions as a result of his investigation under the CA98, the Director does not need to consider whether any issue arises under condition E.

## **SEWERAGE SERVICES**

77. In its original complaint of 12 November 2002 Mid Kent Water made no specific allegations about Southern Water's conduct regarding the provision of sewerage services to the Eurokent site. In its subsequent letter of 15 January 2003 it did refer in passing to Southern Water's conduct in relation to sewerage services; and in its letter of 5 February 2003 (in response to a specific question on the point in a letter from Ofwat dated 30 January 2003) it simply stated that its interpretation of Southern Water's letter of 25 October 2002 was that it covered both water and wastewater services. However, it gave no reason at that stage, and had given and has continued to give no reason, why Southern Water's conduct in respect of sewerage services might have infringed the Chapter II Prohibition. The first section 26 notice to Southern Water of 13 February 2003 required Southern Water to provide Ofwat with copies of all documents relating to the "provision of services (including water supplies and/or waste water services) to the EuroKent Business Park" (see paragraph 15 above). Based on the information provided by Mid Kent Water and Southern Water the Director has no reason, or no sufficient reason, to consider that Southern Water might have abused any dominant position it might hold. Given this, the question of effect on trade in the United Kingdom does not arise.

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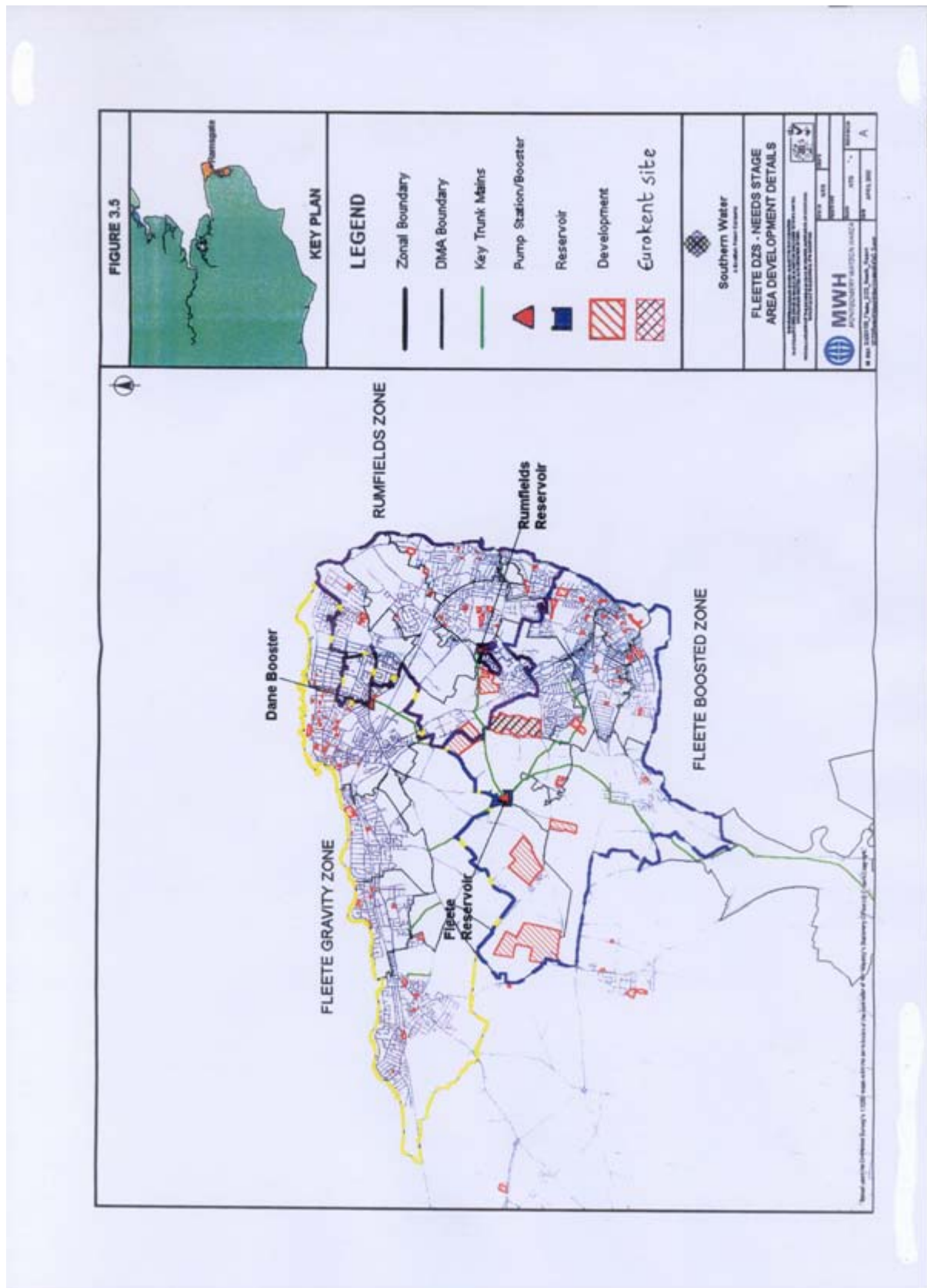
<sup>36</sup> The terms and conditions of a supply for non-domestic purposes under sections 55-56 of the WIA91 are determined by agreement or, in default of agreement, by the Director according to what appears to him to be reasonable (section 56(1) of the WIA91).

<sup>37</sup> Condition E prohibits Southern Water from showing undue preference or undue discrimination in the fixing or the agreeing of the charges specified in paragraph 1 of condition E. The Director has powers under sections 18 to 22 of the WIA91 to enforce condition E. Where a particular practice might fall within the scope of the WIA91 and the CA98, the Director can decide whether to use his powers under the WIA91 or the CA98. In such cases he will make use of whichever statutory powers he judges to be the more appropriate.

## **THE DIRECTOR'S CONCLUSIONS**

78. On the basis of the information in the Director's possession and for the reasons set out above, the Director has decided that Southern Water's conduct is not caught by the Chapter II prohibition of the CA98, and therefore there are no grounds for action on his part.

**ANNEX 1 – MAP OF SOUTHERN WATER’S SUPPLY ZONES IN LOCALITY OF EUROKENT SITE**



## **ANNEX 2 - GLOSSARY**

### **Adoption**

In the water industry, a water or sewerage undertaker “adopts” assets when it assumes responsibility for them.

### **Distribution network**

The network of water mains, as opposed to trunk mains, to which customers are connected, or connect, for the purpose of obtaining a supply of water.

### **Easement**

A right of way or a similar right over another’s land.

### **Main**

A water main is a pipe and any accessories used or to be used by a water undertaker for the purpose of making a general supply of water available to customers or potential customers of the undertaker.

### **Mains Connection**

In the water industry, the connection of a customer to a water main for the purpose of obtaining a supply of water.

### **Off-site**

Outside the development site in question, for example the public highway or land owned by third parties.

### **On-site**

The development site in question.

### **Potable water**

Treated water that is suitable for human consumption.

### **Service pipe**

A pipe which is or is to be connected with a water main for supplying water from that main to any premises.

### **Trunk main**

A trunk main is a main which is or is to be used by a water undertaker for the purpose of conveying from a source of supply to a facility (a treatment works or reservoir) or between facilities or for the purpose of conveying water in bulk between, among other things, one part of the area of the undertaker and another part.