

CO/4719/2009

Neutral Citation Number: [2009] EWHC 3493 (Admin)
IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
THE ADMINISTRATIVE COURT

Royal Courts of Justice
Strand
London WC2A 2LL

Thursday, 10th December 2009

B e f o r e:

MR JUSTICE MITTING

Between:

THE QUEEN ON THE APPLICATION OF WELSH WATER LIMITED_
Claimant

v

WATER SERVICES REGULATION AUTHORITY (OFWAT)_
Defendant

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(Official Shorthand Writers to the Court)

Lord Pannick QC and Mr Iain Steel (instructed by instructed by Messrs Herbert Smith)
appeared on behalf of the **Claimant**

Mr John Swift QC, Mr George Peretz and Mr Ewan West (instructed by Ofwat) appeared
on behalf of the **Defendant**

J U D G M E N T
(As approved by the Court)

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1. MR JUSTICE MITTING: Welsh Water is the statutory water and sewerage undertaker for most of Wales and a small part of England. An undeveloped greenfield site at Llanilid, Bridgend ("the site") is within its area. In 2008, SSE Water applied, with the approval of the developer of the site, to be appointed the water and sewerage undertaker for the site.
2. On 20th November 2008, Ofwat announced its proposal to appoint SSE Water as the water and sewerage undertaker for the site stating that it considered that the proposal would "increase competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services". It invited submissions on the proposal. Welsh Water made detailed submissions against it to no avail. On 3rd March 2009, Ofwat appointed SSE Water as the water and sewerage undertaker for the site. An "information bulletin" of 12th March 2009 briefly explained why:

"Customers on the site will pay no more than they would have done had they been served by Dwr Cymru [Welsh Water], while customers will also benefit from a level of service at least as good as Dwr Cymru's."

3. Under section 195A of the Water Industry Act 1991 as amended, Ofwat was obliged to explain the reasons for its decision and did so in a letter to Welsh Water on 9th April 2009. The reasons included:

"... our assessment of applicant's proposals includes analysis of their plans to ensure customers will be at least no worse off in terms of annual bill and levels of service."

4. In so doing, Ofwat followed its policy published in February 1999 in a document giving guidance for applicants:

"... inset appointments are an important means of introducing more competition to the water and sewerage industry as they allow some customers, particularly large ones, to choose who provides their water supply and sewerage services. They provide for one supplier to be replaced by another for a specific geographical area."

The principles upon which Ofwat would assess so called inset appointments were set out in key points in the guidance:

"that Ofwat must be satisfied that a potential inset appointee will be able to finance the proper carrying out of its functions as water and/or sewerage undertaker; and

that customers whose supplier is changed should be no worse off than if they had remained with the incumbent."

5. Welsh Water was minded to challenge that decision by judicial review proceedings and served a letter before claim on 16th April 2009 which prompted the following reply on 30th April:

"The reason why we take that 'no worse off' approach - rather than requiring the applicant to demonstrate that customers on the site will (or will be likely to) provide a positive improvement - is that the latter approach would amount to a presumption in favour of the existing appointment holder and against granting inset appointments to a new entrant, and thereby impose a competitive disadvantage on an applicant compared with the incumbent. A presumption against granting inset appointments to a new entrant would distort the choice available to a developer such as Cofton when it comes to select the appropriate provider of water infrastructure and services on an unserved site, which is one of the few areas in which competition is presently able to take place in the water sector."

6. In this claim, permission for which was granted by Silber J on 23rd July 2009, Welsh Water challenge the decision to make SSE Water the water and sewerage undertaker for the site and do so by challenging the lawfulness and rationality of the policy pursuant to which the decision was made. The success or otherwise of the challenge turns upon that issue only.
7. The water supply industry is vertically integrated. Suppliers of water undertake all activities from extraction to delivery to the end user by a fixed infrastructure. The industry is therefore a natural geographically bounded monopoly on a regional or local scale. When privatised following the enactment of the Water Act 1989 (re-enacted without relevant modifications by the Water Industry Act 1991), Parliament's concern was primarily to secure the provision of universal supply by financially sound undertakers.
8. Section 2 of the 1991 Act imposed duties on the Secretary of State and on the then director of Ofwat to exercise and perform the powers and duties mentioned in subsection (1) in the manner considered best calculated:

"(a) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and

(b) without prejudice to the generality of paragraph (a) above, to secure that companies holding appointments ... as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers."

Subsection 2(3) required the Secretary of State and Director to exercise and perform the statutory powers and duties in a manner best calculated to achieve a number of objectives. One of them contained in subsection 2(3)(e) was "to facilitate effective competition, with respect to such matters as he considers appropriate, between persons holding or seeking appointments under that Chapter".

9. Section 2 was amended by the Water Act 2003. It now provides:

"(1) This section shall have effect for imposing duties on the Secretary of State and on the Authority as to when and how they should exercise and perform the following powers and duties, that is to say...

(b) in the case of the Authority, the powers and duties conferred or imposed on them by virtue of those provisions, by the provisions relating to financial conditions of requisitions or by the provisions relating to the movement of certain pipes.

(2A) ... the Authority shall exercise and perform the powers and duties mentioned in section (1) above in the manner which ... it considers is best calculated-

(a) to further the consumer objective;

(b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;

(c) to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and

(d) to secure that the activities authorised by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.

(2B) The consumer objective mentioned in subsection (2A)(a) above is to protect the interests of consumers, wherever appropriate, by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services."

10. Subsection 2(5A) defines "consumers" as including "both existing and future consumers" and "the interests of customers" as meaning:

"... the interests of consumers in relation to -

(a) the supply of water by means of a water undertaker's supply system to premises either by water undertakers or by licensed water suppliers acting in their capacity as such; and

(b) the provision of sewerage services by sewerage undertakers."

11. Section 2A further requires Ofwat to have regard to such guidance as may be issued from time to time in relation to Wales by the Assembly with respect to appointment areas which are wholly or mainly in Wales but the duty is limited: first, by the fact that the guidance may only be issued in respect of "any social or environmental policies set out or referred to in the guidance"; secondly, by the fact that Ofwat is only required to

have regard to it; and finally because Ofwat is, by subsection 2A(3) only required to have regard to that guidance in the exercise and performance of the powers and duties mentioned in section 2(1) above. Insofar as guidance from the Assembly goes outside the scope of social or environmental policies, or conflicts with the express statutory duties imposed by section 2, it must give way to the statutory duty.

12. Section 6 provides for the appointment of statutory undertakers and imposes general duties and gives general powers to them. Section 7 (which has contained its current wording apart from the substitution of the word "Authority" for "Director" since 1st July 1992) deals with the termination and variation of appointments. Section 7(3) permits the Secretary of State or Ofwat to terminate an appointment but only if a new undertaker is able immediately to replace the outgoing incumbent. Section 7(4) deals with variation and replacement of undertakers:

"An appointment or variation replacing a company as a relevant undertaker shall not be made in relation to the whole or any part of the area to which that company's appointment as water undertaker or, as the case may be, sewerage undertaker relates except where-

(a) that company consents to the appointment or variation;

(b) the appointment or variation relates only to parts of that area none of the premises in which is served by that company;

(bb) the appointment or variation relates only to parts of that area and the conditions mentioned in subsection (5) below are satisfied in relation to each of the premises in those parts which are served by that company..."

The latter provision relates to large industrial use. Accordingly, without the consent of the incumbent, it may only be replaced in parts of its area which are not served by it (typically greenfield development sites)

or in respect of the supply of water to large industrial consumers.

13. The basic contention of Lord Pannick QC for Welsh Water is that before Ofwat can exercise the power under section 7(4)(b) to replace an incumbent in an area not served by it (known in the trade as an "inset appointment") it must satisfy itself that the appointee would provide a service more beneficial to consumers (as to either price, service, innovation or any combination of them) than would the existing incumbent.
14. He defines customers for that purpose as either or both of the prospective consumers in the inset site or existing and prospective consumers of the incumbent undertaker. He submits that Ofwat's February 1999 policy does not achieve or tend to achieve that end.
15. Mr Swift QC for Ofwat submits that Lord Pannick's test is an unwarranted gloss on the words of section 7(4)(b) and that experience has shown that Ofwat's policy does in fact have the effect of protecting the interests of consumers by promoting appropriate competition.

16. It is trite law that a policy must be capable of furthering the objective of the statute under which it is devised. The relevant objectives here are to be discerned from the words of section 2 and for present purposes those contained in section 2(2A)(a) "to further the customer objective". That objective is, as defined by section 2(2B), the protection of the interests of customers by promoting effective competition -- where that is the appropriate means of protecting their interests -- and, if not, then by other means.
17. The consumers whose interests are to be protected are in my judgment all existing and future customers, not just existing or future customers in the inset site or existing or future customers who are served by the incumbent undertaker throughout its area. The means available to Ofwat of promoting effective competition are limited to the appointment of a non-incumbent undertaker in an inset site, to the appointment of a non-incumbent undertaker to supply large industrial users and the ability to require wholesale suppliers of water to make supplies on appropriate terms to retail suppliers under chapter 2A of the 1991 Act.
18. Ofwat considers that appointing non-incumbent undertakers chosen by developers of greenfield sites is a worthwhile method of promoting effective competition. In an extended passage of evidence, Ofwat's director of markets Ms Ross, explains why:

"In the context of an industry whose essential structure is one of price-regulated vertically-integrated, regional monopolies with generally high barriers to entry, new appointments provide one of relatively few means of providing competition to the incumbent undertaker...

In our view, it is important to promote competition for inset appointments since such competition is likely to benefit consumers as a whole...

The process by which the existing incumbent monopoly is replaced by the new monopoly inset appointee is a competitive one. It is not competition 'in the market' in the sense that the two companies compete head to head on an ongoing basis for each customer. But it is competition 'for the market'.

Where inset appointments are made under the unserved criterion, a successful applicant must ... necessarily have been chosen as the supplier by the developer of the site: it must therefore have offered a benefit to the developer vis-à-vis the existing incumbent...

Furthermore, there are direct benefits to customers from inset appointments. Out of the nine inset appointments we have granted to new appointees since 2007, five offer a discount on the tariff that customers would have received from the incumbent appointee (either the volumetric rate or both the volumetric and fixed rates). The initial discount offered has been around 5% although one new appointee currently offers volumetric discounts of around 17% and 12% on two of its sites. There is also scope for improvement on customer service. One inset appointee is

targeting full compliance with Ofwat's service standards and a near-perfect score on levels of service indicators. It is putting together a customer code of practice that combines the best of every incumbent's service levels. A second inset appointee is targeting 'best in class' levels of service and performance.

Inset appointments also provide a vehicle for innovation. In particular, inset appointments provide opportunities for companies to reveal new types and methods of service provision not only through provision at the retail level but also through network design, build and operation. [She then goes on to give a particular incidence] ...

In addition to the benefits that accrue to developers, to customers on the site, and more generally through innovation, by providing a route by which incumbent monopolists face a challenge to their business inset appointments act as a spur for incumbent monopolists to raise their game. Obviously, as an economic regulator, we do our best to provide such a spur through regulation. But there are always limits on the extent to which regulation can mimic the effects of the market and in our view, the threat of actual competition (even if 'for' rather than 'in' the market) is a valuable addition."

She gave further examples in a second witness statement:

"In practice, the inset appointee acts as a spur for innovation in relation to network design, build and operation by providing developers with a fully managed package, not only laying the necessary infrastructure but also operating it and providing end services to customers...

In addition, inset appointments also deliver innovation by allowing the provision of multi-utility services to the site. In delivering multi-utility services, the developer benefits from the resulting economies of scale and scope in two ways. First, a single trench can be used to deliver not just the water supply, but other services such as gas and electricity. Second, the developer has a single point of contact with whom to deal...

Furthermore, Ofwat has clear empirical evidence that the process of making inset appointments leads to technological innovation." [for which she cites an earlier example]

19. Ofwat's view is that, if the hurdle for new entrants is placed higher than its existing policy, these benefits will be put at risk. As Ms Ross explains in her third witness statement:

"... Ofwat's main reason for considering that it should not place unnecessarily high hurdles in the way of an applicant for an inset appointment is that new entry into the market is likely to, and in Ofwat's experience does, bring incentives for existing incumbents to raise their

game, through efficiency and innovation..."

20. This evidence cannot in my judgment be lightly rejected. It is the accumulated experience of the specialist regulator applying a consistent policy for over ten years. The evidence is that it is working. Ms Ross refers in her first witness statement to the fact that, since 1997, 22 inset appointments have been made and that the rate of applications for inset appointments has recently increased sharply. 45 were received in 2008 compared with one in 2005, three in 2006 and 9 in 2007. All but two of the applications were from companies new to the water sector.
21. A policy which is intended and effective to achieve the statutory objective is one which cannot be described as unlawful or irrational, even though a different or more tightly drawn policy, like that for which Lord Pannick, contends, might have been chosen. This policy, which, as I have demonstrated, appears to work, is neither unlawful nor irrational. Ofwat was and remains entitled to apply it. It does, of course, keep it under review. There may come a time when it wishes to change it, but it is the expert regulator in the field and it is its judgment on such matters, provided that the judgment falls within the generous range given to it by the statute, which counts.
22. It is not required to demonstrate that a definable benefit will accrue to prospective residents on the site or to other customers of Welsh Water within the whole of its area. Insofar as the Welsh Assembly considers otherwise, its view must give way to those expressed in section 2 of the Act. Under the heading "social objectives and social policy", the Assembly gives the following guidance:

"Competition

75. One of Ofwat's objectives is to protect the interests of consumers of regulated water and sewerage services, wherever appropriate through promoting effective competition.

76. The approach to competition is ultimately a decision for government. Subject to any review and any legislative changes that may arise as a result, the Welsh Assembly Government currently takes a cautious approach to competition, focusing on the benefits to the generality of customers.

77. In pursuing its statutory duty to protect customers by promoting effective competition and innovation and by acting against anti-competitive behaviours, the Welsh Assembly Government expects Ofwat to demonstrate the benefits for customers. In assessing such benefits, the Welsh Assembly Government expects Ofwat to demonstrate that these outweigh the drawbacks of increasing competition, including that there are no detrimental consequences for the generality of customers across Wales and that the long term interests of consumers are safeguarded. In the meantime, however, Ofwat should be introducing more innovative regulation, including new proposals on differing tariffs especially for the low income and vulnerable sectors.

78. Ofwat should not introduce competition where it is incompatible with maintaining adequate protection to public health, the environment and the quality and security of public supplies."

23. Much of that guidance is unexceptionable and Ofwat claims to have been able to follow it. But, insofar as the Welsh Assembly has a dimmer view of the benefits of competition than does Parliament, its views must give way to those of Parliament. Ofwat did have regard to that policy. Ms Ross' view that it sat comfortably with its own policy and with the statutory requirements may be generous but, insofar as it is, it has not caused Ofwat to formulate or implement a policy that is outwith its statutory remit. In my judgment, the Ofwat policy is lawful and rational and it was entitled to apply it as it did to this site.
24. MR SWIFT: My Lord, in those circumstances, may I ask your Lordship to dismiss the application with costs for the respondent?
25. MR JUSTICE MITTING: Yes.
26. LORD PANNICK: I cannot resist that, my Lord. I do have an application for leave to appeal on the basis that the case does raise issues of general importance about the proper construction of the 1991 Act as amended.
27. MR JUSTICE MITTING: I acknowledge that the issues raised are of importance and are of importance for the people of Wales, but I simply cannot see how a different outcome is likely to be achieved by an appeal and so I think you must ventilate the matter before the Court of Appeal if you wish to. I refuse permission.
28. Thank you both for very interesting and well presented and economically presented arguments.