Albion water and the ECPR

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The CAT's views: context specific

- *835. In our view ECPR is not a safe methodology to use in this case for the purpose of determining the reasonableness of the First Access Price because: (i) the 'retail' price used in the calculation is not shown to be cost-related as regards the distribution element; (ii) the evidence strongly suggests that that price is itself excessive; (iii) the particular method of ECPR used in this case would eliminate the existing competition and in effect, preclude virtually any competitive entry, because the resultant margins are insufficient; and (iv) the approach of the Authority to avoidable costs in its evidence and submissions was not the same as that in the Decision.*

CAT’s view that the Authority did not focus on the facts of the case

- *749. The Authority’s position is that “given our extensive regulation of retail prices and focus on continuing efficiency improvements we do not think the concern about ECPR preserving monopoly profits or inefficiency is relevant to the water industry” (Annex C to Professor Armstrong’s First Report). In our view, that optimistic statement does not focus on the specific facts of this particular case.*
- *750. In this specific case, the evidence before the Tribunal is that there was, at the material time, no relevant regulation of the retail prices of non-potable water to large industrial customers in Wales using more than 250 Ml per annum ….*

Lack of supporting evidence for the Authority's decision

- *757. In those circumstances, the central problem facing the Tribunal is that there is no evidence that the prices in these various special agreements relied on as comparators in setting the price in the Second Bulk Supply Agreement were related to the costs of supply, and if so in what way…….If the price in the Second Bulk Supply Agreement of 26p/m³ is not cost-justified, and since the evidence strongly suggests that that price was excessive, it does not in our view assist that that price is based on a comparison with other prices which are not cost justified either. We add that the only contemporary evidence we have which purported to give some cost justification for the price under the Second Bulk Supply Agreement (D21 to the Reply) has been abandoned by Dŵr Cymru, with the Authority's support,as not offering "incremental insight" (Jones 2, paragraph 16).758.*

Asymmetry between incumbent and entrant under ECPR?

- *799. It was further accepted by the Authority that under ECPR a new entrant would need to be "super-efficient" as compared with the incumbent. Thus at Day 2, pp. 72-73 there was the following exchange:*

  "THE PRESIDENT: Could I just, on the last topic, Mr Hope - you have been very patient, so thank you very much for your help - go back to this basic point? Is it not the case that the new entrant is effectively bearing two sets of overheads, his own and the incumbent's? In those circumstances would a new entrant have to be not merely as efficient as the incumbent but super-efficient in order to make any realistic stab at entering in an effective way? Would that be a fair way of putting it? A. I think it would…"

No competition without duplication?

- *802. Although the entry of a further competitor may to a certain degree add to total costs in the short run, the general assumption of competition policy is that in the longer run the competitive process will lead to lower costs overall. What the Authority describes as "the duplication" of fixed costs is not normally regarded as a problem. As Dr Marshall points out, in competitive markets a certain duplication of fixed costs is inherent in the fact that there are a number of competitors each of whom has their own costs and overheads. But, in normal circumstances, competitive markets will still produce goods and services at lower costs than will be the case if the market is monopolised.*

Facts matter

- *812. Moreover, in Professor Armstrong's view it is not merely that ECPR does not assist in these circumstances: ECPR is not appropriate if there is a potential risk of bypass, in his view. It seemed clear to us that Professor Armstrong was not aware that the possibility of the Ashgrove system being bypassed by an alternative pipeline had been raised by the Authority in connection with the issue of dominance (see the Decision at Annex I). Professor Armstrong's view quite clearly was that, if bypass is a potential possibility or danger, following ECPR does not produce an appropriate access price, and a price based directly on the cost of providing access, with a mechanism for recovering universal service costs, would be preferable (Day 4, p. 14). We accept the logic of this view. If an ECPR calculation sets an access price so high that bypass (alternative pipes or development of boreholes) may be encouraged, one simply brings about the duplication of fixed costs and stranded assets that ECPR is designed to avoid, which is self-defeating.*

The weight to be given to productive/cost efficiency

- ECPR doesn’t address issues of allocative and dynamic efficiency.
- The theoretical “frame” is one of equilibrium *states*, rather than of a competitive *process*.
- In effect, the ECPR rule constrains the competitive process in the name of not violating an end-state efficiency condition. Odd when you think about it.
- Similar arguments appeared in relation to market reforms in electricity – “we must preserve the merit order in electricity generation”. Rejected by policy makers.
- Thesis: It is necessary for the competitive process that productive efficiency conditions are sometimes violated: less efficient competitors must sometimes be able to win. Rules that prohibit such victories are liable to be anti-competitive in their effects.

Some underlying (static) economics: there is more than one externality

- Product selection theory (Spence).
- Under conditions of scale economies, new entrants steal business from incumbents and imposes efficiency losses thereby (a negative externality). ECPR addresses this.
- But they also create additional consumer surplus (a second, and positive, externality).
- We tend get “excess entry” results when entrants add little new (‘me too’).
- On the other hand, if only the first (business stealing) externality is corrected, there is liable to be too little entry.
- CAT position: on the facts, ECPR, as applied by the Authority, would lead to the second outcome.