

Water and DG Competition

by

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May 2003

This report was commissioned by the European Public Services Union (EPSU) www.epsu.org

1	INTRODUCTION	2
2	FALSE ASSUMPTIONS	2
2.1	EFFICIENCY ASSUMPTIONS.....	2
2.2	CONFLICTING INTERESTS?.....	4
2.3	MONOPOLY, PUBLIC SECTOR AND PROFITS.....	4
3	EMPIRICAL EVIDENCE	4
3.1	A 'KEY TEST' IGNORED.....	4
3.2	THE UNDISCLOSED EVIDENCE FROM MEMBER STATES.....	5
4	COMPETITION – INCOHERENT	5
4.1	UNSOUND GENERALISATION.....	5
4.2	INCOHERENCE AND VERTICAL INTEGRATION	6
4.3	COMPETITION, COST RECOVERY, OUTSOURCING 'NOT OF INTEREST'	7
5	LEGAL ASPECTS	7
6	CONCLUSIONS AND CONFUSIONS	7
6.1	WARNINGS OR ENCOURAGEMENT?.....	7
6.2	SWEEPING COMPLAINTS AND MEANINGLESS CONCLUSIONS	8
6.3	HIDDEN CONSULTATION:.....	8
	NOTES	10

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1 Introduction

At the start of 2002 DG competition commissioned a report into the water sector, which was delivered in December 2002.¹ It has received little publicity or public debate, and was carried out without consultation of major stakeholders, for example trade unions.

The report however is of importance because it is intended to support DG Competition's policy of promoting liberalisation and privatisation in the water sector. This policy was most explicitly stated by Commissioner Bolkestein in a speech in November 2002, where he spoke of the need to introduce market forces into the water sector, and that once the Water Framework Directive is implemented, then water can be treated as a cross-border product and so subject to competition rules.² Other recent initiatives have encouraged privatisation and liberalisation in the water sector, including a strategy paper from DG Market,³ guidelines for accession countries from DG Regional Policy⁴, the GATS demands submitted by DG Trade for the opening of the water sector⁵, and the EU Water Initiative⁶.

This paper offers a critique of the report, which was intended to justify EC intervention to promote liberalisation in water in Europe. However, it fails to offer the evidence or argument needed - it relies largely on generalised arguments; assumes, without demonstrating, the superior performance of private operators, and ignores key features of private interests in this sector, such as the overwhelming dominance of two multinationals who frequently work together.

2 False assumptions

2.1 Assumed benefits of liberalisation in water

The report makes assumptions about the benefits of liberalisation from the outset, without justifying them. It implies, without offering any evidence or reference, that liberalisation is certainly most efficient than public ownership: *"there will be always be a tension between the balance of establishing an optimal economic model and resulting efficiencies for the sector, and the political priorities of those responsible for providing the service"* (page 2). But this is certainly not true in natural monopolies such as water, where private sector free market behaviour produces worse results than political decision-making: a recent elegant demonstration of this was published by Johann Willner⁷, supported by an extensive survey of empirical studies on the relative efficiency of public and private sector operators in various sectors which shows that there is no overall evidence of superior efficiency by the private sector.

Indeed in water, as in other sectors, much empirical evidence suggests that public sector water systems may be more efficient. Two examples are given here. The table below shows a comparison between Swedish public water companies, and UK private water companies

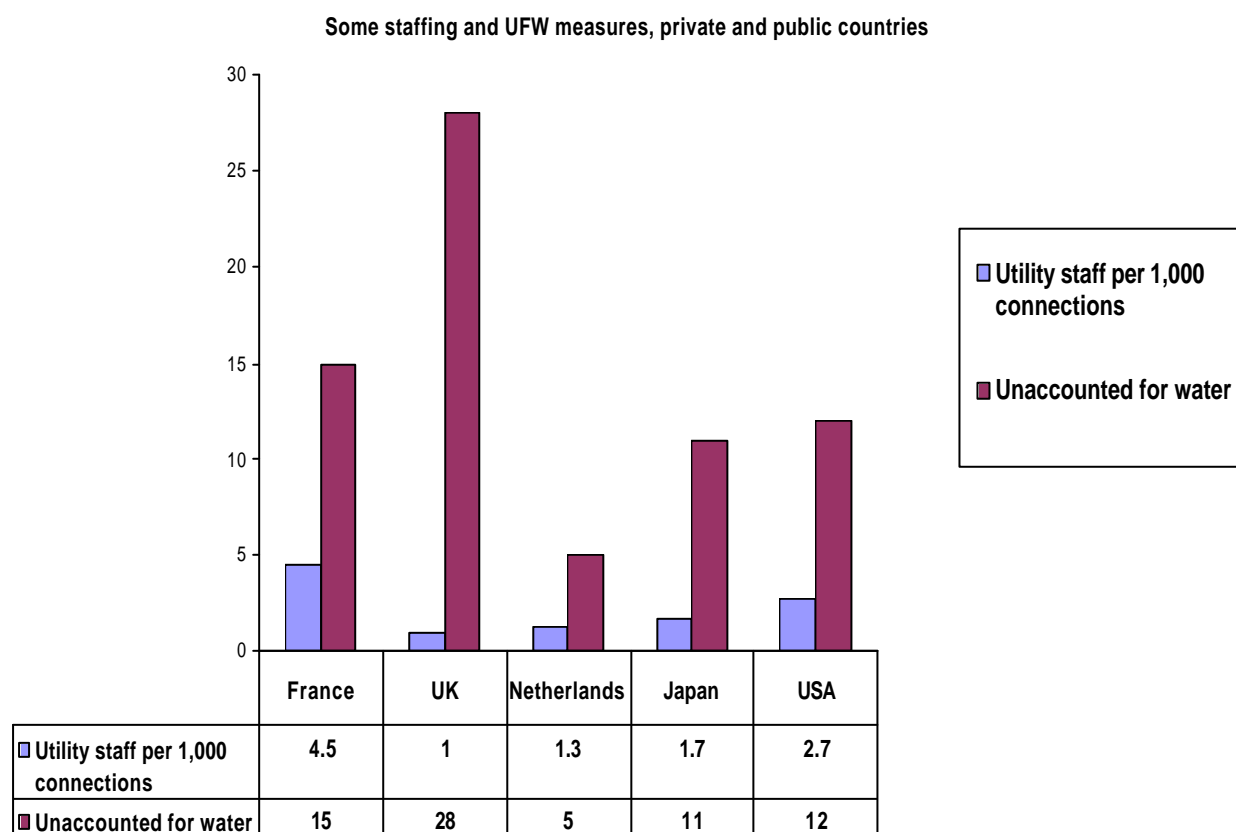
Table 2. Water costs: a comparison between Swedish and English cities, 1995

Cost per cubic metre of water delivered, purchasing power parities, US\$. M = municipally owned; P = privately owned;

Water company	Ownership	Cost to customer	Cost of operation	Capital maintenance	Return on capital
Stockholm	M	0.28	0.17	0.03	0.09
Manchester	P	0.91	0.40	0.20	0.31
Bristol	P	0.83	0.48	0.19	0.15
Gothenburg	M	0.38	0.11	0.05	0.21
Kirklees	P	0.99	0.52	0.31	0.15
Hartlepool	P	0.73	0.35	0.08	0.29
Helsingborg	M	0.42	0.42	0.05	-0.05
Waverley	P	0.82	0.48	0.22	0.12
Wrexam	P	1.25	0.57	0.35	0.32
Swedish average		0.36	0.23	0.04	0.08
British average		0.93	0.48	0.20	0.23

(Source: ITT, as in Hall 1998⁸)

The chart below shows that on measures like leakage or staffing levels, countries with public sector systems emerge with better performance than the largely privatised operators of Britain and France.⁹



Source: Water in Public Hands, 2001

The report makes similar unwise assumptions about other sectors, such as energy, for example claiming that: *“The influence of competition policies on monopolistic economic sectors such as telecommunications and energy has created efficiency improvements and benefits for customers in terms of lower prices and a greater diversity in services and choices for consumers”* (p.1) - an assertion which is repeated in the concluding remarks of the paper (section 7.1, p. 93).

However, it is in fact highly doubtful whether energy liberalisation has delivered efficiency benefits or improvements for consumers in general. For example, the experience of the UK, where liberalisation of electricity markets has been longest established, suggests that whereas large industrial consumers enjoy lower prices reflecting falls in fuel costs, domestic consumers do not get the benefit of price reductions because their custom is not worth competing for.¹⁰

2.2 Conflicting interests?

The report also claims, defensively, that attempts to extend ‘competition’ into new sectors such as water is *“indicative of a pressure to seek further efficiencies in the cost base of Europe’s economic activity...it is not about the promotion of private sector participation, nor is it about liberalism per se.”*(p.1). This is naïve: the large European private water companies are long-established lobbyists at EC level, whose aim is, quite naturally, to promote private sector participation¹¹: and the report itself specifically encourages this when it recommends that consultation should specially involve private groups *‘with business aspirations to enter the sector’* (p. 139). The question that should be asked is whether the interests of these aspirants conflict with the public interest.

Even on the same page, the report seems to accept that liberalisation may conflict with the public interest, e.g. in health (p.1); and that commercial operators may behave anti-competitively, and not necessarily deliver reduced prices to consumers (e.g. the final paragraph on page 1). At the end, the report is aware that enabling liberalisation involves a radical restructuring of political systems: opening the sector up to competition would involve *“significant reform”* which would affect *“the political and governance structures of many of the member states municipalities.”* (p.94)

2.3 Monopoly, public sector and profits

The report claims that monopoly is not just an issue for private sector operators are involved, but that *“an abuse of monopoly position can be just as applicable in the public sector as well as the private sector”* (p.2). But there is a key difference: a private sector operator has a constant incentive to maximise the private profit taken from a monopoly – clearly observable in private water concessions¹² - whereas a public sector operator does not.

The report in effect treats public sector operators as though they can only be profit-maximising commercial entities with an unusual shareholding structure. However, this ignores the crucial point about public sector provision - public ownership is a mechanism for seeking to ensure that public interest considerations replace monopoly profiteering by private companies. This does not mean that the public sector cannot make profits, but that they are subject to public control – a point not recognised in the report’s discussion of competition, which refers to apparently limitless subsidies being characteristic of the public sector (see below). Yet the section which reviews the case law of the ECJ (section 5) does make clear that for the ECJ the public sector is primarily a provider of public services, not a commercial entity in competition with the private sector (see below).

3 Empirical evidence

3.1 A ‘key test’ ignored

The issues surrounding actual practice are mentioned at a key point in the text, in 4.8 when discussing ‘competition for the market’: *“The key test to the successful implementation of competition pressures in these areas is the degree of ‘contestability’ that exists for each contract and the processes that ensure*

transparency and opportunity and that deal with concerns related to incumbent advantage and possible collusion.” (p.53 - this test is restated in the concluding section, p.94).

However, the rest of that section ignores this ‘key test’, and nowhere does the report draw on empirical evidence of the actual contestability, transparency, incumbent advantages and collusion. Yet a brief study of the industry should find evidence which is extremely relevant to this ‘key test’. The water industry in Europe and worldwide is dominated by 2 companies which share about 70% of the global market; which act together in joint ventures with each other and their competitors in a number of countries; which prefer to keep contracts secret; which have had executives of their water subsidiaries convicted of corruption in France, Italy and the USA; and which defend their existing contracts with considerable legal energy.¹³

3.2 The undisclosed evidence from member states

The report does include empirical data, in the annexes which set out the regimes in member states. The data was scrutinised by Eureau representatives, but Eureau represents producers who may have vested interests in how the systems are described. Whether as a result of this or otherwise, the annexes on those few EU countries which use private operators to any extent – France, Spain and the UK - omit reference to important problematic experience with these private regimes. For example:

- The section on France asserts that “*The water services activities operated by private companies have contracts which are temporary, transparent and reversible*” (p.109) which is complacently incorrect in view of the evidence of corruption, secrecy, and incumbent advantage revealed by the report of the French Cour des Comptes in 1997¹⁴ and subsequent problems of transparency and reversibility revealed by the case of Grenoble inter alia.¹⁵
- The section on Spain fails to make clear the extent of private concessions, and fails to note the problems of reversibility experienced in the recent contract renewal at Valencia (where Aguas de Valencia now enjoys a concession which started in 1902 and will not be subject to competition until 2051)¹⁶.
- The section on the UK fails to note that the water companies were given 25-year concessions, without competition, in 1989, and that, thanks to a recent initiative by OFWAT, they now enjoy the right to 25 years’ notice before their concessions can be submitted to competition.¹⁷ It notes the recent development to replace private equity capital with long-term debt (p. 132), but fails to explore the significance of this development in the body of the report.

These issues have a real consequence for arguments about competition in the industry, because they stem from corporate resistance to accepting any kind of political or regulatory risk, and reluctance to see equity tied up in long-term investments. The only point in the report that refers to the actual experience of non-competitive behaviour is the reference in 5.1.5 (p. 65) to the ruling in France that Vivendi and Suez had colluded by forming joint ventures to avoid competition, but this is not referred to elsewhere in the report.¹⁸

4 Competition – incoherent

4.1 Unsound generalisation

The section on the economic aspects of the industry is a strange mixture of general observations and painful attempts to find a niche for ‘competition’. It observes rightly that in water “*There are significant externalities (social costs and benefits) and many parts of the industry are widely viewed as natural monopolies*”(p. 26). However, when discussing these social costs and benefits it offers the confused assertion based on jumbled neo-liberal prejudices, that “*Frequently the over riding concern on water services solely as a “social good” has meant that services have been provided at subsidised prices or for free, thereby increasing the potential for wasteful use and providing no incentives to ensure efficient water use and re-use.*”(p.28).

This is an empirically unsound generalisation, which ignores the fact that water charges have often been used to finance other public services, for example the former common practice of German stadtwerte in cross-subsidising public transport from profitable operations such as water and energy - and also ignores the cases where the private sector may subsidise water by submitting loss leader bids to obtain contracts.

But it also confuses at least two issues – one is the distribution of finance between user charges and central or local taxation, which should not be mis-represented as ‘free’ – for example in the Republic of Ireland there are no water charges, but the costs of water supply are paid for through taxation, not received ‘free’; and another is the incentive effects of metering, which is an interesting issue which needs discussion not economic assumption.¹⁹ Similar confusion about public sector practice is repeated elsewhere, e.g. in 3.4.3 on cost recovery, and 3.4.4 on volumetric charging, 4.3.2 on cost recovery).

The section on capital provision (3.4.2) shows the same inclination to rely on received neo-liberal wisdom rather than empirical evidence. Capital finance is a central issue for the water industry, and should address the practice and pros and cons of public or private sector finance mechanisms. But the section only alludes in passing to the most common source of finance for investment, the use by municipalities (and/or central governments) of bonds or long-term bank loans; fails to explain that this source has been seriously affected by EU and national restrictions on government debt; and fails to engage in any discussion of why private companies are avoiding equity in favour of debt (see above). Instead, it lists some mechanisms involving private companies, which it inaccurately describes as “innovative”: for example, the system of private concessions was prevalent in the 18th century - it is a relic rather than an innovation.²⁰

4.2 Incoherence and vertical integration

The report descends further into incoherence when discussing vertical integration and competition (3.4).²¹ It notes the possibility of vertical separation of bulk supply and distribution, and then goes on to claim that the ‘theoretical’ benefit of such separation is “*that they can be provided by different entities in a competitive environment. This may take the form of sub-contracting....or franchising...or outsourcing ...or competitive bidding*”. (p. 29 - this paragraph is repeated twice, in a slightly different order)

Firstly, this ignores the simple and central reason for such a split, which is that the most efficient scale for catchment management is much larger than municipalities, the normal distribution unit. As the paper itself has just pointed out, bulk water is a regional function, and distribution a municipal one, in “*many European countries*”, without any vestige of competition: they are typically public authorities with different statutory functions. Indeed, the paper itself later correctly identifies the issue: “The disadvantages of disaggregation are that it entails higher transaction costs” (4.4, p.42).

Secondly, sub-contracting (or franchising, or outsourcing – these terms mean the same in this context) can happen just as easily whether there is vertical integration or not - for example, of construction, or billing, or IT. The report appears unaware of the extent to which contracting-out happens at present, and especially the extent to which it is used by public sector as well as private operators – indeed, one feature of public sector operation is that more ancillary services are likely to be exposed to competitive tender than is the case with public sector operators, who prefer to assign work to their own subsidiaries without open tendering (see below).²²

Further confusion is evident in 4.8, on ‘competition for the market’ (by which is meant competition for monopolies). It first discusses delegation of concessions and then adds: “*there is significant evidence that efficiencies can be made through the competitive outsourcing of construction and some operation activities. In Germany for example, most of these are contracted out, resulting in much of the water industry’s cost base being subject to some market influences.*” Again, this concerns outsourcing in general, not the special case of the allocation of monopoly operating concessions.

Its discussion of horizontal integration is very limited, and based on limited data. It fails to note, for example, that the dominant companies in water – Suez, Vivendi and RWE – are also the dominant waste management companies in Europe.²³

4.3 Competition, cost recovery, outsourcing ‘not of interest’

The section on competition is equally confused and confusing. It states correctly at the outset that “*Competition is not an end in itself*”(p.36), but continues to consider the feasibility of competition with little reference to its consequences compared with other options. We get a long section on full cost recovery (4.3), which is a different issue from competition – full cost recovery can be practised by public or private monopolists, and often is. Then there is a section on market segments (4.4), which identifies a large segment of functions including engineering, IT, pipe maintenance etc and then declares “*these market segments are ancillary services or activities and are not the central concern of this study*” (p.45).

But why not? This is a large proportion of water and sanitation work, which is quite easily and simply subject to competition through existing EU procurement regimes, and there are important issues raised by experiences with outsourcing in a number of utilities. These include: problems for the quality of public services which arise as a result of outsourcing (e.g. training,²⁴ responsibility for standards and delivery of service, structural developments across utilities (e.g. the development of specialist billing operators such as Vertex in the UK).²⁵ Moreover, whereas public sector operators contract out using competitive procurement procedures,²⁶ private companies are prone to reserving privileged contracts for their own subsidiaries, without competition²⁷ – and so private operation may actually reduce the prospects of competitive outsourcing of supplies or services.

The most likely explanation is that the authors of the paper understand very well that the main interest of DG competition in this subject is in fact to explore how much more of the EU water industry can be privatised, to the benefit of the water multinationals. Sub-contracting is of not much interest, and in any case is already simply available: so the report is expected – despite its denials (p. 1) – to focus on the prospects for private sector operation.

5 Legal aspects

This section has an account of case law as it stood in 2002 concerning the exemption available under 86(2) for services of general interest (SGI), such as water, and the question of state aid. The case of BFI Holdings is referred to, where the ECJ held that in cases where certain needs in the general interest could not be rendered sufficiently by private companies, the State may require that activity to be carried out by public authorities or organisations over which it wishes to retain a decisive influence.²⁸

6 Conclusions and confusions

6.1 Warnings or encouragement?

After 92 pages the report offers ‘concluding remarks’. The first section, labelled ‘general issues’ (7.1), restate some of the points made earlier in the report, e.g. ‘competition is not an end in itself’, ‘the water industry does not fit easily into standard economic theory’ this may be a problem created by their limited view of economic theory).

It then restates some views on the conditions for competition which can be read two ways - either as warnings against the drastic effects of trying to impose a competition regime, or as encouragement to radical action by DG Competition.

One of these is the statement that “*the granting of third or fourth party access is fundamental to the establishment of a competitive water network*” (p. 94) for competition in the market. Another is the restatement of the test that “*The key test to the successful implementation of competition pressures in these areas is the degree of “contestability” that exists for each contract and the processes that ensure transparency and opportunity and that deal with concerns related to incumbent advantage and possible collusion.*”

It points out that most of the competitive models proposed would be disruptive of political structures: *“Within the current structure of the industry in Europe, mainly a municipal responsibility with a large variety of service providing entities developed in most states, it is likely that many of these models would be unachievable without significant reform of the sector. This reform would have impacts not only for the water and wastewater service providers themselves, but also for the political and governance structures of many of the member states municipalities.”* (p.94) It is not clear if this is a warning against meddling, or an encouragement to constitutional boldness on the part of DG Competition.

6.2 Sweeping complaints and meaningless conclusions

The recommendations in 7.2. concerning competition, are both weak and alarming, and bear little relation to the body of the report except the section on legal cases. They start, in effect, by re-stating some obvious legal truths - that abuse of dominant position is covered by EC law, that concessions do not have to be tendered under procurement procedures, and that bid-rigging agreements are illegal.

They then add that ‘restrictive agreements’ between bulk water suppliers and distributors could violate EC competition law under article 81, and excluding companies from access (to the grid?) could be in breach of article 82. These are sweeping suggestions if they are meant to apply to public sector bodies, as seems to be the case, which have not at all been justified by reference to the impact on services and accountability.

There is then a complaint about the decisions on state aid, with the non-specific conclusion that the EC will find it harder to discover infringements; and so *“in view of the ever more competitive character of the sectors”* – a point nowhere substantiated - *“there is a clear need for transparency”* – a lamely non-specific conclusion. The section on regulation (7.3) makes no real attempt at recommendations, and instead continues with complaints against the use of words in EU debate on this issue: *‘the language of “competition” has been inherently confused and entwined with the language of “privatisation” and “liberalisation”’. The issues and the language of competition is distinct and is about processes and structures, and regulation that supports efficiency, high quality of services and competitive price’*. It also includes a paragraph which literally meaningless and refers to a non-existent Directive on Concessions:

“Regulatory solutions are no substitute a clarification of the water and wastewater industry as a service of general economic interest and therein if the sector must conform with the EU Treaty provisions for competition rules. This will then provide a basis for clarifying the position on the application of the Directive on Concessions in the water and wastewater sector. In the Chapter 5 this position is discussed.”. (p.96, quoted verbatim)

The one coherent recommendation in 7.3 is to support the idea that collecting and sharing information on finances and performance would *“increase competitive pressures on the industry”*. But it is misleading to treat information sharing as a benefit linked to competition in any way, even in the context of this report: section 6 reported that countries which are 100% publicly owned and vertically integrated, with no regulator, such as the Netherlands, can and do have systems for gathering and sharing information which result in high levels of efficiency. And so the interests of the citizens can be satisfied directly by collecting and sharing information, without it being mediated through a system of competition, with its additional costs and risks.

6.3 Hidden consultation:

The report kept its distance from stakeholders: the sources of information listed do not include any stakeholders representing consumer, labour or environmental interests. The report was asked to cover consultation, but its *“Proposed strategy for a possible consultation of interested third parties”* is hidden away in Annexe 2b, and not referred to at all in the body of the report.

Annex 2b offers a list of stakeholders who should be consulted, but this list does not include environmental groups, or unions, or general consumer groups – only ‘special customer interest groups’ such as large industrial consumers or vulnerable categories such as pensioners or the disabled. It does however include

governments, municipalities, regulators, public and private providers, and private groups *'with business aspirations to enter the sector'* (p. 139)

This list gives pre-eminence to suppliers and providers, and the annexe reinforces this by emphasising the key role of Eureau: *"In particular it would be very important to open up consultations with EUREAU and with the relevant national trade associations in each country"*. Despite its own lack of any clear recommendations and conclusions, the report assumes that DG Competition will have proposals to promote, and suggest that consultation should proceed: *"perhaps through a "road-show" of meetings and presentations in each member state. This could begin with a seminar or conference sponsored by DG Competition as a way of developing wider awareness of the subject and to build confidence in the process of developing any emerging policy for the sector..."* (p.138)

NOTES

¹ “Study On The Application Of The Competition Rules To The Water Sector In The European Community” December 2002. Prepared By Wrc And Ecologic For The European Commission - Competition Directorate General Study Contract No. Comp/2002/E3/Si2.334052

http://europa.eu.int/comm/competition/publications/studies/water_sector_report.pdf

² Commissioner Bolkestein on water, 7 November 2002: see

http://europa.eu.int/comm/internal_market/en/speeches/spch-02-543_en.htm)

³ http://www.europa.eu.int/comm/internal_market/en/update/strategy/index.htm

⁴ *Guide to Successful Public-Private Partnerships*

http://europa.eu.int/comm/regional_policy/sources/docgener/guides/ppp/ppp_en.pdf

⁵ For leaked information on the requests, and a critique, see <http://www.wdm.org.uk/campaign/gats109leaks.htm>

⁶ This was developed in close consultation with the companies; see

<http://www.corporateeurope.org/water/infobrief6.htm>

⁷ See Johan Willner, Ownership, efficiency, and political interference. *European Journal of Political Economy* Volume 17, Issue 4 November 2001 Pages 723-748

http://www.sciencedirect.com/science?_ob=JournalURL&_cdi=5891&_auth=y&_acct=C000027518&_version=1&_urlVersion=0&_userid=634187&_md5=6ac93d487a034cb29c63df9a9f415a82

⁸ Hall, D. (1998b) Restructuring and privatization in the public utilities – Europe, in De Luca, L. (Ed.) *Labour and social dimensions of privatization and restructuring (public utilities: water, gas and electricity)*. Geneva: published for the International Labour Office, pp. 109-151.

⁹ From “Water in Public Hands” PSIRU 2001 <http://www.psiru.org/reports/2001-06-W-public.doc>

¹⁰ See for example Stephen Thomas “The Impact on Small Consumers of Retail Electricity Competition” June 2002

<http://www.psiru.org/reports/2002-06-E-UKretail.doc>

¹¹ A recent example of this is the EU water Initiative: see <http://www.corporateeurope.org/water/infobrief6.htm>

¹² See for example the case of Grenoble *Private to Public: International lessons of water re-municipalisation in Grenoble, France* August 2001 <http://www.psiru.org/reports/2001-08-W-Grenoble.doc>

¹³ See for example “The Water multinationals 2002 - financial and other problems” (PSIRU, August

2002) <http://www.psiru.org/reports/2002-08-W-MNCs.doc>

¹⁴ Cour des Comptes “la gestion des services publics locaux d'eau et d'assainissement” janvier 1997

<http://www.ccomptes.fr/Cour-des-comptes/publications/rapports/eau/cdc72.htm>

¹⁵ See note above.

¹⁶ see Psiru Submission To The International Development Select Committee 5th November 2002

[HTTP://WWW.PSIRU.ORG/REPORTS/2002-11-WB-IDC.DOC](http://www.psiru.org/reports/2002-11-WB-IDC.DOC)

¹⁷ See for example the licence of United Utilities at

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/lic_northwest.pdf/\\$FILE/lic_northwest.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/lic_northwest.pdf/$FILE/lic_northwest.pdf)

(p.125).

¹⁸ Sourced by the report to Decision No 2-D-44 of 11 July 2002, French Competition Council, available at:

<http://www.finances.gouv.fr/conseilconurrence>

¹⁹ See for example Colin Green on ‘Economics and Water’ at the Watertime Workshop April 2003

<http://www.watertime.net/docs/WPI/Colin%20Green%20WaterTime%20Greenwich%2011%20Apr%2003.ppt>

²⁰ For a fuller discussion of water finance issues see “Financing water for the world – an alternative to guaranteed profits” March 2003 <http://www.psiru.org/reports/2003-03-W-finance.doc>

²¹ The report repeats the two main paragraphs twice, in slightly different order, on p.29

²² See for example

²³ See “Waste Management Multinationals 2002” January 2002 <http://www.psiru.org/reports/2002-01-Gc.doc>

²⁴ See e.g. ‘An Assessment of Skill Needs in the Gas, Water and Electricity Industries’. By Fiona Harris & Corinne Church, Business Strategies July 2002 <http://www.dfes.gov.uk/skillsdialoguereports/docs/SD10UTILITIES.doc>

²⁵ For example over rail crashes in the UK see <http://www.guardian.co.uk/pottersbar/story/0,11994,802252,00.html>

²⁶ Including cases such as Stockholm Vatten and even the water company of Porto Alegre, Brazil: see

<http://www.psiru.org/reports/2002-08-W-dmae.pdf>

²⁷ See *Private to Public: International lessons of water re-municipalisation in Grenoble, France* August 2001

<http://www.psiru.org/reports/2001-08-W-Grenoble.doc>

²⁸ The key cases are: C-320/91, *Corbeau* [1991] ECR I-2533, para. 11; C-41/90, *Höfner* [1991] ECR I-1979, para. 29; C-159/94, *Commission v. France* [1994] ECR I-5815, para. 59; C-393/92, *Almelo* [1994] ECR I-1477, para. 49; C-360/96, *Gemeente Arnhem and Gemeente Rheden v BFI Holding BV*, [1998] ECR I-6821, para. 52;