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More documentation related to this discussion can be found at: oe.cd/gfc26.

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Croatia

1. Background and initiation of proceedings

1. The Croatian Competition Agency received a submission from the Croatian Consumer Protection Association requesting the initiation of proceedings to determine whether Ponikve had abused its dominant position and seeking an order prohibiting any continuation of the alleged conduct.

2. The request submitted by the Croatian Consumer Protection Association indicated, in essence, that Ponikve adopted the Decision on the method of payment and the level of prices for municipal services, which established the method of payment and the prices for water supply, wastewater drainage and treatment, and the collection and disposal of waste and faecal matter in the territory of the island of Krk, by dividing households into 32 consumer categories according to the annual volume of water consumed.

3. Ponikve applied different household tariffs according to annual water consumption, with prices ranging from HRK 5 to HRK 70 per m³ for water supply and from HRK 1.90 to HRK 23.00 per m³ for wastewater drainage and treatment.

4. Pursuant to the Competition Act, the CCA conducted a preliminary examination of conditions in the water supply and wastewater drainage and treatment market before adopting a decision to initiate proceedings. That preliminary examination was conducted in order to determine whether there were grounds for initiating proceedings to establish an abuse of a dominant position by Ponikve in the market for supplying households with water through the water supply network and for the drainage and treatment of household wastewater in the territory of the island of Krk, consisting in the direct or indirect imposition of unfair purchase or selling prices, as prescribed by law.

5. The Competition Act, Croatia's general framework for competition law, also applies to legal persons established by local self-government units or in which those units hold interests.

6. Ponikve was established by the local self-government units on the island of Krk—namely, the Town of Krk and the municipalities of Malinska-Dubašnica, Dobrinj, Baška, Punat, Vrbnik and Omišalj—as well as by Hrvatske vode, for the purpose of providing municipal services on the island of Krk pursuant to the Utilities Act.

7. Ponikve, established by the local self-government units on Krk and Hrvatske vode, operated as a natural monopoly with no competitors in water supply and wastewater drainage and treatment on the island. Its dominant position within the meaning of the Competition Act was therefore undisputed.

8. For the purpose of assessing the market conditions and deciding whether to initiate proceedings in the present case, the CCA requested Ponikve to respond to the allegations made by the Croatian Consumer Protection Association and to submit an economic analysis of its operating costs and water-pricing methodology demonstrating the need to establish 32 consumer categories, together with the water-price calculation used to determine a different selling price for each consumer category.

9. In submissions, Ponikve responded to the allegations made by the Croatian Consumer Protection Association, disputing them in their entirety. It explained that consumers were divided into 32 different categories because fixed operating costs accounted for 95% of all costs and were borne by the undertaking throughout the year,

rather than only during the four summer months in which as much as three quarters of total annual water consumption occurred. The undertaking also enclosed the Tariff System for Water Distribution in the Service Area of the Municipal Utility Company Ponikve Krk, prepared by the Hrvoje Požar Energy Institute.

10. Having reviewed the submissions of Ponikve and the submitted Tariff System for Water Distribution in the Service Area of the Municipal Utility Company Ponikve Krk, the CCA found no evidence demonstrating the economic justification for charging consumers on the island of Krk different water prices by dividing them into 32 categories according to annual water consumption, so that consumers using less water annually paid a higher price per m^3.

11. The CCA adopted a decision to initiate proceedings against Ponikve to establish whether competition had been prevented, restricted or distorted through an abuse of a dominant position, consisting in the direct or indirect imposition of unfair purchase or selling prices.

2. Relevant markets and position of Ponikve

12. The Agency identified two closely connected relevant product markets: (i) the supply of water to households through the public water network; and (ii) the collection and treatment of household wastewater. Although analytically distinct, the two services are highly vertically integrated. In particular, wastewater charges are generally linked to the volume of water consumed, while the development of a water supply network is a prerequisite for the construction and operation of wastewater infrastructure.

13. The relevant geographic market was defined as the island of Krk. Ponikve was established by the Town of Krk, the municipalities of Malinska-Dubašnica, Dobrinj, Baška, Punat, Vrbnik and Omišalj, and Hrvatske vode to provide municipal services on the island. Its activities were therefore limited to, and organised around, the local infrastructure serving that territory.

14. Under the Utilities Act, drinking-water supply and wastewater collection and treatment may be provided by a company or public institution established by a local self-government unit, an in-house service unit, or a legal or natural person operating under a concession or service agreement. Approximately 130 undertakings provided water supply and wastewater services in Croatia, most of them limited liability companies controlled by local or regional authorities. Within this institutional framework, Ponikve operated as the sole provider on Krk and therefore held a dominant position in the relevant markets.

15. Notwithstanding local differences in the quality of water sources, water-resource management generally proceeds from the premise that water is scarce and should be treated as such by both legislators and system operators. Sustainable management of water resources is therefore of particular importance.

3. Economic characteristics of the water sector

16. The provision of water services involves a vertically connected chain of activities comprising abstraction, collection, treatment and distribution through the public network. Water is supplied principally to household, agricultural and industrial users. Wastewater collection and treatment form a closely related service chain, given the technical links between consumption, sewerage infrastructure and treatment capacity.

17. The sector exhibits the principal characteristics of a natural monopoly. The operator must develop and maintain extensive local infrastructure, while the duplication of networks would generally be inefficient. These structural features, combined with the interdependence of successive stages of supply, tend to support a single provider within a defined geographic area and create a need for effective oversight of access conditions and tariffs.

18. Vertical integration reflects the technical interdependence of abstraction, collection, treatment and distribution. Although these activities may be performed by separate operators, each stage is necessary for the delivery of the final service. In the present case, Ponikve controlled the entire supply chain, reinforcing its position as the natural monopolist and increasing the importance of effective oversight of its pricing practices.

19. One of the characteristics of the water supply industry is that it is a capital-intensive sector. This characteristic is reflected in the very high proportion of non-current or fixed assets revealed by vertical analyses of the financial statements of undertakings operating in this industry. This high proportion results from the need to invest in water supply networks, plants for the treatment of collected water, sewerage systems and similar infrastructure.

20. These assets very often also include wastewater treatment plants, which likewise constitute fixed assets.

21. These long-lived assets require substantial investment and constitute the largest item on the undertaking's balance sheet. The associated fixed costs dominate its cost structure, are incurred before operating revenue begins and create high market-exit costs. Variable costs, by contrast, account for a much smaller share of total costs.

22. Water distribution entails substantial infrastructure and operating costs, which contributes to the local character of water markets. Networks are typically developed within defined service areas, as transporting water over longer distances or duplicating existing infrastructure is generally uneconomic. Although the island setting accentuated these features in the present case, they are characteristic of the sector more broadly.

23. Household demand for water is highly price-inelastic because the service is essential and consumers have limited scope to reduce consumption below basic-needs levels. This weak demand response increases consumers' exposure to price increases and strengthens the case for effective oversight of tariffs imposed by a monopoly provider. At the same time, tariff design should preserve appropriate incentives for efficient and sustainable water use.

24. In view of all the above characteristics of the water supply sector, particularly those reflected in very high market-entry costs and high market-exit costs, the water supply market is generally characterised by a natural monopoly within the geographic area in which the water distributor has constructed a water supply network through which it supplies final consumers.

25. From a technical perspective, planning and constructing a water supply system is a complex process comprising the abstraction of water from the environment, the collection or storage of water, its treatment and distribution to consumers, while the process of wastewater collection and treatment includes wastewater collection, processing and treatment, stormwater management, and sludge processing and wastewater treatment.

26. From an economic perspective, the specific features of the water management market and activities are reflected in the capital-intensive nature of the sector, the exceptionally high proportion of fixed costs in undertakings' total costs, and the vertical integration of the system, whose individual components in the vertical chain are highly interdependent.

27. Ponikve operated across the full water supply chain on the island of Krk, from abstraction and treatment to distribution to households and businesses. It also provided wastewater collection services, although the sewerage network covered a more limited area. Its control of the principal water and wastewater infrastructure further reinforced its position in the relevant markets.

4. Cost recovery and tariff design

28. Water pricing in the activity under review is based exclusively on costs. This approach uses microeconomic analysis to identify total costs and their fixed and variable components. The tariff structure should reflect the characteristics of the water supply system and its operator, generating sufficient revenue to recover the full costs of supply without additional profit.

29. In water supply, fixed costs account for a substantial share of total costs and are therefore central to cost analysis and tariff setting.

30. In a natural monopoly, marginal-cost pricing provides a benchmark for socially efficient water pricing. However, it does not generate sufficient revenue to recover fixed costs.

31. A two-part tariff addresses this shortfall by combining a fixed charge, calculated by dividing total fixed costs by the number of consumers, with a volumetric charge set at marginal cost. Under this approach, the tariff would achieve full cost recovery.

32. In assessing Ponikve's alleged abuse of dominance, the Agency drew on EU competition law, policy and water-sector practice. It considered the economic principles governing water supply, particularly full cost recovery as a central principle of economic regulation and oversight.

33. Following its cost analysis, the Agency examined the tariff structure, which determines both the operator's revenue and the charges paid by consumers.

34. Tariff setting is the principal instrument for managing water services, determining revenue and ensuring cost recovery. A tariff structure defines the components of the consumer's total bill. Water supply tariffs include the following models:

a) A flat-fee tariff bases charges on criteria such as property value or floor area, rather than the volume of water consumed.

b) A uniform volumetric tariff applies the same price to each unit of water consumed.

c) A two-part tariff, the most commonly used model, comprises two charges. The first is a fixed amount payable for a specified period.

35. The second charge is generally based on the volume of water consumed. Tariff structures may include one or more of the following components:

- A connection charge, payable once upon connection to the network.
- A fixed charge for a specified period, generally uniform across consumers or based on criteria such as meter size or property value. It typically covers billing, meter maintenance and reading, and system depreciation.
- A volumetric charge in a metered system, calculated by multiplying consumption during the billing period by the price per unit.

- A block tariff, with different unit prices for defined consumption bands. Increasing block tariffs apply higher unit prices as consumption rises; decreasing block tariffs apply lower unit prices.
- • A minimum charge, based on a specified minimum volume irrespective of actual consumption during the billing period.

36. Volumetric charges may also vary seasonally, particularly in tourist areas where consumption fluctuates with the population. Resource scarcity becomes more significant during high-demand periods, and the system must be designed to meet peak demand.

37. Household water prices in Croatia comprise the public water supply provider's service charge, the water-use and water-protection charges, the concession fee and value added tax (VAT), with the service charge and associated charges calculated on a volumetric basis.

38. The data indicate that revenue generated from charges paid by households for water supply services does not cover the full economic costs of water supply and wastewater drainage. Current water prices are sufficient only to cover basic maintenance costs and emergency interventions in the systems. Costs arising from system losses due to leakage, costs associated with the development of the water supply system, and investment costs intended to reduce economic and environmental externalities are not included in the current price of water.

5. Assessment of Ponikve's tariff system

39. The water supply tariff in question divided consumers into 32 categories defined by annual water-consumption bands. The first covered consumption up to 10 m³, followed by bands of 5 m³ through the 29th category. The 30th category spanned 50 m³, the 31st spanned 300 m³, and the 32nd applied to consumption above 500 m³.

40. Unit prices generally declined as consumption increased, falling from HRK 70.00/m³ in the first category to a minimum of HRK 5.00/m³ in the 30th category, before rising slightly in the final two categories.

41. It follows from the above that Ponikve applies, throughout most of the price list concerned, a decreasing block tariff system and, from the 31st consumer category onward, an increasing block tariff system, in both cases without a fixed charge and with a total of 32 blocks.

42. In the present case, Ponikve attempted to incorporate a fixed charge into the volumetric charge, which resulted in adverse effects for certain consumers. In addition, the price list contains a number of inconsistencies and does not encourage consumers to use water rationally at a price level that would maximise their utility; on the contrary, it encourages speculative behaviour.

43. These inconsistencies arise both at the inter-category level (between different consumption blocks) and at the intra-category level (within the same consumption block). For example, an inter-category inconsistency is apparent from the total price set for annual water consumption of 10 m³, which amounts to HRK 700, while the price for consuming 11 m³ amounts to HRK 660. The total price for consuming 15 m³ amounts to HRK 900, while the price for consuming 16 m³ amounts to HRK 720. Furthermore, the price for consuming 17 m³ amounts to HRK 765, while for 18 m³ it amounts to HRK 810, and so forth.

44. The tariff disadvantaged certain consumers and created incentives to increase consumption beyond their needs, as unnecessary water use could result in a lower bill than consumption sufficient to meet those needs. Within individual consumption categories, the tariff imposed unequal financial burdens on consumers.

45. The tariff charged HRK 900 for 15 m³ but only HRK 825.00 for 150 m³, rewarding substantially higher consumption with a lower bill and thereby encouraging unnecessary water use.

46. Like the water supply tariff system, the price list for wastewater drainage and treatment applied by Ponikve follows the same underlying logic and displays the same inconsistencies, as a result of which there is no linear or logical relationship between consumption and the price paid for that consumption.

47. Consequently, consumers are not guided by rational consumption or consumption based on their needs but obtain a greater financial benefit when they consume water unnecessarily. In this way, they reach a consumption level that provides them with a greater financial benefit, that is, they pay a lower charge.

48. Comparative EU systems and practice show that tariffs for wastewater drainage or treatment are set either as a fixed charge linked to parameters such as the floor area of the property, or by using a volumetric system in which the chargeable quantity is based on the volume of water consumed.

49. The amendments of tariff revised prices for individual categories but retained the 32-category tariff structure. Only the final two categories had lower consumption thresholds.

50. The CCA found that the revised tariff retained the earlier inconsistencies and discriminatory effects, including the non-linear relationship between consumption and the total bill.

51. The only difference lay in the revised prices for individual consumer categories. It is assumed that, by making this adjustment to the price list, Ponikve sought to correct one of the inconsistencies in the earlier price list for the consumption range between 65 and 145 m³ of water. In that part of the previously analysed price list, the relationship between the prices, that is, the charges paid by individual consumers, was particularly irregular.

52. This represents an exceptionally irregular relationship between the volume of water consumed and the price charged for annual water consumption.This price list likewise reveals inconsistencies and creates a need for certain consumers to engage in strategic behaviour when using water. Such consumers obtain a financial benefit only through that behaviour.

53. Thus, a consumer whose reasonable use would result in annual consumption of, for example, 15 m³ of water may choose among several consumption volumes in order to obtain a financial benefit from such strategic behaviour.

54. Water consumption of, for example, 16 m³, 21 m³, 26 m³, 31 m³ or 36 m³ would provide that consumer with a greater financial benefit than consumption at the required level of 15 m³.

55. Subsequent price changes retained the 32-category structure. Prices changed in parallel across categories, leaving the underlying relationship between consumption and charges unchanged.

56. The CCA therefore reached the same conclusions regarding inconsistencies within and between categories and adverse effects on certain consumers.

6. Recovering fixed costs through the volumetric charge

57. The Agency assessed the effects on consumers of recovering fixed costs through the volumetric charge. It used two approaches: allocating 95% of each bill to fixed costs and 5% to variable costs, consistent with the reported cost structure; and assuming a uniform fixed charge per consumer.

58. Under the second approach, the Agency assumed an annual fixed-cost contribution of HRK 800 per consumer. This illustrative benchmark exposed unequal cost allocation: some consumers' bills fell below their assumed fixed-cost contribution, while others covered that contribution and paid a higher amount towards variable costs.

59. Consumers with annual consumption of 15, 20 or 35 m³, or more than 50 m³, paid bills sufficient to cover the assumed fixed-cost contribution and a variable-cost component. By contrast, consumers using 16, 21 or 36 m³ annually, or less than 15 m³, paid bills that did not cover the assumed fixed-cost contribution.

60. The same results would arise with any other assumed fixed-cost amount per consumer. This demonstrates the unacceptability of a tariff system that results in unequal treatment of certain consumers relative to others. A tariff system in which an attempt is made to incorporate the fixed charge into the volumetric calculation of charges necessarily places some consumers at a disadvantage relative to others and is therefore neither acceptable nor applied in any country within the European Union.

7. Classification by monthly consumption and seasonal status

61. The CCA found that classifying consumers according to different levels of consumption during individual months of the year, and the resulting Decisions on the method of payment and the level of prices for municipal services, including their amendments, had a discriminatory effect.

62. It also found that the assertion made by Ponikve in its submissions to the CCA — that a different method of setting tariffs would privilege "occasional" consumers over "permanent" consumers—was incorrect. When a water supply system and the related infrastructure are constructed, the system does not distinguish between "permanent" and "occasional" consumers.

63. The water supply network must serve all consumers across Krk. Permanent residents live in both inland and coastal settlements, while occasional residents are distributed across the island's coastal settlements. A comprehensive island-wide network is therefore required to meet the needs of both groups.

64. Constructing the water supply network entails substantial costs. A larger consumer base, comprising both permanent and occasional users, spreads those costs more widely and reduces the average fixed cost per consumer over the long term.

65. Average fixed costs are calculated by dividing total fixed costs by the number of consumers. It is therefore clear that increasing the number of consumers in the denominator of the formula reduces average costs. Likewise, increased consumption and, consequently, increased production on an annual basis led to lower marginal production costs.

66. The ideal system for setting water supply service charges would combine a fixed charge with a volumetric charge reflecting the marginal costs of supply.

67. The water supply system also operates on the principle of solidarity, with costs averaged and shared collectively among consumers. This approach avoids the complexity of calculating consumer-specific supply costs.

68. The principle of solidarity should also be considered in relation to the summer surcharge for designated purposes of HRK 1.50 per m^3, applicable from 1 June to 30 September.

69. Given the pattern of consumption, it may be concluded that, both relatively and absolutely, a larger share of the total funds collected on this basis is derived from "occasional" consumers.

70. The revenue finances investment in Krk's water supply network, including extensions to areas without a supply. These investments include the central Dobrinj area, where tourism is limited and residents are predominantly permanent. Part of the investment is funded by the summer surcharge.

71. Accordingly, Ponikve's assertion that, without such a tariff system, "occasional" consumers would be privileged, while permanent consumers would be placed at a disadvantage could meaningfully be reformulated to state that "occasional" consumers finance infrastructure from which they do not benefit.

72. However, such a claim would not be appropriate, because the principle of solidarity inherent in the water supply system requires all consumers to contribute jointly to the development and maintenance of the system and precludes placing individual consumers or categories of consumers at a disadvantage.

73. The specific circumstances of permanent island residents should be addressed through public-policy measures rather than differentiated tariffs. The provider's water price must nevertheless remain the same for all consumers; support should be delivered through transfers to avoid discrimination between consumer groups.

74. The CCA analysed all the technical and economic specificities of the water supply activity. In this regard, it should be concluded that costs arise within the water supply system even when the final product itself—water—is not used. The principles of solidarity and equality among all consumers indicate that a charge for maintaining and managing the system is justified, provided that it is levied in an equal amount on all consumers over a specified period. This is usually calculated monthly.

75. On the basis of a comparative review of practice in the European Union, the Agency concluded that such a charge, in the form of a fixed and/or minimum charge, exists in almost all European Union member states.

76. Professional expertise and comparative practice have demonstrated which tariff systems satisfy, on the one hand, the requirement of non-discriminatory treatment of all consumer categories and, on the other, the requirement to secure sufficient financial resources for managing the water supply system so as to ensure its sustainability and development.

8. Tariff systems on comparable Croatian islands and European Union

77. As part of its economic analysis, the Agency compared the tariffs of water supply undertakings operating on selected Croatian islands. These included Vodovod i čistoća Cres Mali Lošinj, based in Cres and serving Cres and Mali Lošinj; Hvarski vodovod, based in Jelsa on Hvar; Vodovod Brač, based in Supetar on Brač; and Komunalno društvo Pag, based in Pag on the island of Pag.

78. The Agency selected these undertakings on the basis of their presumed similarity to Ponikve in technical operating conditions and consumption patterns, and because they operated under the same legislative framework.

79. The four undertakings exhibited similar seasonal consumption patterns, with drinking-water demand rising markedly from June to September. Their shared island setting and provision of water supply, wastewater drainage and treatment services provided a representative basis for comparing tariff structures.

80. The comparative analysis of the tariff systems applied by the selected undertakings engaged in water supply activities on certain islands in the Republic of Croatia—which have characteristics very similar to those of Ponikve, both technically and in terms of the structure and nature of consumption—established that the tariff system applied by Ponikve constitutes a unique method of setting the price of water.

81. By contrast, tariffs on the comparator islands were coherent and equitable, irrespective of whether they included a seasonal component. They applied the same unit price to all consumers, with differences in bills reflecting actual water consumption.

82. The CCA's review of tariff systems in selected EU Member States identified no model comparable to Ponikve's. Finding no comparable tariff model in selected EU Member States strengthened the CCA's assessment that Ponikve's structure was unusual, rather than a necessary response to high fixed costs or seasonal demand.

9. Finding of infringement

83. The CCA found that, in the present case, it had been conclusively established that Ponikve, as a natural monopoly holding a dominant position on the relevant market for supplying households with water through the water supply network and for the drainage and treatment of household wastewater on the island of Krk, had, within the meaning of the competition rules, restricted competition by abusing its dominant position on that relevant market through the direct imposition of unfair selling prices.

84. The economic and legal analysis established that Ponikve imposed unfair selling prices that discriminated against consumers. Its tariff divided households on Krk into 32 categories according to annual water consumption, applying different unit prices for water supply and wastewater drainage and treatment. The resulting charges lacked a coherent relationship with consumption.

85. The tariff disadvantaged consumers both between and within categories. Rather than encouraging consumption according to need, it created incentives for unnecessary water use, as higher consumption could result in a lower bill.

86. In view of the findings above, the CCA decided to order Ponikve to adopt a new Decision on the method of payment and the level of prices for municipal services, establishing new prices for supplying households with water through the water supply

network and for the drainage and treatment of household wastewater on the island of Krk without imposing unfair selling prices.

87. Ponikve must comply with this order without delay and no later than three (3) months from the date on which this decision is served.

88. Ponikve may choose its tariff model, provided that it avoids unfair selling prices and unequal treatment of consumers, ensures the efficient operation of water supply, wastewater drainage and treatment systems, and promotes the conservation of water as a natural resource of particular importance to Croatia.

89. In adopting its decision, the CCA considered Croatia's commitment to implement the Water Framework Directive (WFD), which recognises water scarcity and the importance of water as a natural resource and incorporates the principles of conservation, environmental protection and full cost recovery.

90. Consistent with these principles, tariffs should promote water conservation and sustainable development by discouraging unnecessary consumption. Ponikve's tariffs instead created incentives for wasteful water use.

91. The comparative analysis of the relevant market in the Republic of Croatia and the EU conclusively established, contrary to the submissions of Ponikve, that such a tariff system can be achieved while respecting the scarcity of water resources and the particular importance of water. Any tariff combination that sought to incorporate the fixed charge into the volumetric charge would place certain consumers at a disadvantage relative to others; consequently, no such tariff combination has been accepted or implemented anywhere in the EU.

92. The CCA interpreted the Consumer Protection Act as permitting an appropriate fixed charge for water services, given the sector's high fixed costs. This is particularly relevant where costs are incurred evenly throughout the year but consumption and revenue are seasonal. Where the charge covers fixed costs used exclusively for system maintenance and sustainable development, the CCA considered that consumers are not paying for water they have not consumed. This interpretation is supported by comparative law and practice in EU Member States, where fixed charges are generally included in water supply tariffs.

10. Conclusion

93. The Ponikve case illustrates the role of competition enforcement in addressing exploitative pricing by a natural monopolist. The CCA's assessment focused on the tariff structure and its effects: differentiated unit prices imposed unequal burdens on consumers and, at certain consumption thresholds, rewarded higher water use with lower bills. High fixed costs and seasonal demand did not justify these outcomes.

94. The broader lesson is that cost recovery and network development must be pursued through coherent, non-discriminatory tariffs that preserve incentives for efficient water use. An appropriate fixed charge can support system maintenance and sustainable development, while the volumetric component should encourage consumption according to need. Competition enforcement can thus complement consumer protection and water-sector policy by reconciling financial sustainability, equal treatment and resource conservation.