

Department for Environment, Food and Rural Affairs

Summary of responses: Call for Evidence on Reform of the Water Special Merger Regime

July 2013

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1. Introduction and background

1.1 The English and Welsh water sector is currently one of the few areas subject to a special merger regime (SMR). Under the Water Industry Act 1991 any proposed merger between two or more water/water and sewerage companies where one or all the companies have an annual turnover of £10 million or more is automatically referred by the Office of Fair Trading (OFT) to the Competition Commission (CC).

1.2 The purpose of the regime is to preserve the ability of the regulator, Ofwat, to make use of “comparative” regulation (i.e. the ability to compare the performance of different water/water and sewerage companies for the purposes of setting robust prices and customer service standards. In the absence of any significant competition in the water sector, comparative regulation is regarded as a particularly important regulatory tool. The greater the number of comparators available, the more effective the approach.

1.3 The loss of certain water companies (or “comparators”) may represent a detriment to Ofwat’s ability to make both quantitative and qualitative comparisons between the companies. A key question that the CC is required to consider in respect of anticipated or actual mergers is whether Ofwat’s ability to make comparisons has been or could be prejudiced by the merger. If this is the case the CC must decide what mitigating action should be taken to offset the loss of the comparator.

1.4 The Cave Review examined the Special Merger Regime (SMR) on the basis that the low jurisdictional threshold (£10m) for the CC to examine a merger was causing a chilling effect on mergers, actually discouraged merger activity between water/water and sewerage companies and that potentially there might be benefits associated with a relaxation of the regime.

1.5 The review proposed two significant changes to the regime:

- Raise the threshold for the SMR to a maximum of £70m and reforming the threshold such that it only applied to the smallest company, as in the wider regime.
- The introduction of a first stage merger test. Based on its published guidance, Ofwat should provide specific advice on a merger to the OFT, including an assessment of the scale of any prejudice. The OFT should consider that advice, as well as any other competition effects arising from the merger and the scope for structural or behavioural remedies (if offered by the parties), when considering the need for referral to the CC.

1.6 The Water White Paper – Water for Life set out the Government’s vision for future water management in which the water sector is resilient, in which water companies are more efficient and customer focussed, and in which water is valued as the precious and finite resource that it is. It committed to the introduction, through the Water Bill, of a two-tier referral system, allowing water companies seeking to merger to make undertakings in

lieu of an expensive referral to the CC. It also committed to consultation to inform on whether a higher £70m threshold was appropriate.

1.7 A Call for Evidence was issued in May 2012 seeking views to assist in the preparation of an Impact Assessment. In particular, the Call for Evidence sought views and evidence on proposals to increase the threshold at which mergers are automatically referred by the OFT to the CC from the current level of £10 million.

2. Analysis of responses

2.1 Twelve responses were received. Eight were from Water Companies (South West Water, United Utilities, Sembcorp Bournemouth Water, Dee Valley Water, Severn Trent Water, South Staffordshire Water, Thames Water, Northumbrian Water), with the remaining responses coming from: Ofwat, The Consumer Council for Water, SSE (formerly Scottish and Southern Energy) and Clifford Chance LLP (legal firm).

2.2 In addition to the summary of responses to the Call for Evidence, we have also included feedback from two work-shops that were held in the summer as part of this evidence gathering exercise. The first work shop was attended by economists and experts and the second by representatives of a number of water companies.

3. Summary by question

Question 1. Is the special merger regime still relevant – does Ofwat need to rely so heavily on comparative regulation?

3.1 Of the twelve responses received, three did not answer this question directly. Of those that did respond, the majority considered that Ofwat's reliance on comparative regulation was decreasing and that there is diminishing scope for productive efficiency. Ofwat was changing the way in which it regulated the sector. Other regulated sectors, such as energy and gas distribution and transmission do not rely so heavily on comparators and have moved towards alternative methods that encourage companies to seek efficiencies. The introduction of market reform and competition should help incentivise innovation, service improvement and further efficiency and require less reliance on comparators.

3.2 Clifford Chance LLP considered that there may be scope for the normal merger regime to consider the impact of a merger on a comparative regulatory regime and that the onus should be placed on Ofwat to justify why a SMR is needed for the water sector.

3.3 CCWater believed that the current regime had ensured that customers are compensated when a merger has led to a weakening of Ofwat's ability to carry out effective comparative regulation to the benefit of customers. They considered that a revised merger regime should act in the interests of consumers by setting a regulatory

precedent that customers receive a share of the short term costs savings that a merger will deliver.

3.4 Thames Water considered the SMR should be removed from legislation and sufficient protection for customers and Ofwat's regulatory framework would be provided through the normal merger regime.

3.5 Two respondents, Dee Valley Water and Ofwat considered that the regime was still relevant. Dee Valley wanted to see real evidence that a change in the regime would lead to benefits and questioned the statement in the "Call for Evidence" that Ofwat has been as effective at regulating the sewerage sector with just 10 comparators as it had the water sector.

3.6 Ofwat commented that they still considered the SMR relevant so long as water and sewerage services are provided by monopoly companies. They are considering a number of different approaches to cost assessment, which is one of the ways they use comparators, as part of the Future Price Limits project. However, they stated that even if their approach to costs assessment changes, they will need comparators for the foreseeable future. However, there was recognition that the introduction of competition could lead to less reliance on comparators.

Question 2. Should the £10 million threshold be increased – Why?

3.7 All twelve respondent answered this question to some extent with the majority stating that the threshold should be increased. A number of respondents suggested that the SMR should be abolished entirely. SSE asserted that the current regime is unduly restrictive and that the wider efficiencies that could be achieved by mergers are not being realised. Thames Water stated that economic regulation does not depend on the use of comparators – the key intention of RPI-x was that efficient costs would be realised by the companies rather than predicted by Ofwat. South Staffs pointed out that the low threshold ignores the fact that the larger companies are unlikely to change their performance in response to a merger involving a smaller company. Severn Trent considered that a £70m threshold might appear to be an improvement but it would only exclude 4 water only companies.

3.8 Ofwat asserted that the SMR does not prohibit mergers. However, they recognised that the SMR has a chilling effect on mergers due to the time and costs associated with a reference to the CC. Ofwat believed that the loss of any comparator would have a detrimental effect as their use of comparators is much broader than simply econometric efficiency modelling. They stated that replacing the automatic referral to the CC with a decision on whether to refer to the CC would reduce the chilling effect of the regime and enable it to develop as both markets and their new regulatory model evolved.

3.9 Clifford Chance LLP stated that if the SMR is to be retained then there is value in a threshold even if as low as £10m as this would allow for mergers between inset appointees. However, retaining the threshold and rejecting the other Cave recommendations would signal that the likely cost to the industry through the loss of a

comparator was considered greater than the benefits of any future merger and the chilling effect would continue.

3.10 Dee Valley did not want to see the threshold increased. They claimed that low price is the key indicator of efficiency in a truly competitive market – four of the five lowest average water bills are from companies with a turnover below £70m suggesting that benefits will not necessarily accrue to customers from economies of scale.

Question 3. Should the threshold be increased to £70 million?

3.11 All respondents answered this question. Nine respondents supported raising the threshold to at least £70m with Northumbrian Water suggesting that £400 million was an appropriate level. However, Sembcorp considered that there was insufficient data/evidence to support any specific higher threshold. CCWater considered that £70m was the maximum level that the threshold should be set at and Dee Valley considered that raising the threshold could act against competition and reduce innovative ways of service improvement.

3.12 Ofwat said that a turnover threshold of £70m is an arbitrary number and appeared to come from the general merger regime. They considered that there is no single number below which mergers are likely to be cost beneficial and above which they will not – the circumstances of all mergers would be different. Any new threshold should be based upon an objective assessment of the number and type of comparators that Ofwat would require to continue to effectively regulate and the industry and protect customers.

Question 4. What alternative might there be to setting a threshold in order to exempt mergers between and with water-only companies (e.g. just applying the regime to mergers of water and sewerage companies)?

3.13 Seven respondents answered this question. Of those that responded the majority did not consider that exempting water only companies from the SMR was the right approach, nor was the 25% share of supply test, as applied in the normal merger regime, considered to be appropriate.

3.14 Dee Valley considered that the current regime was satisfactory and therefore alternatives were not considered. CCWater was supportive of an increase in the threshold to £70m as it could facilitate water company mergers.

3.15 Severn Trent considered that, in line with Ofwat's risk based approach to regulation, removal of the SMR would allow the same protections under the latest OFT/CC guidance. If sufficient undertakings were offered the OFT could allow a merger without a reference to the CC.

3.16 Thames considered that the question that should be asked was whether the industry should be subject to the SMR or normal merger rules. It said that any changes by Government to the SMR, for example between water only and water and wastewater

companies would have the unintended consequences of predetermining what an efficient industry structure looked like.

Question 5. What are the benefits of further mergers as a result of an increase in the threshold? Would the benefits exceed the potential cost to the wider sector by reducing Ofwat's ability to regulate?

3.17 A number of water companies commented that the benefits could include economies of scale, transfer of best practice (including innovation), increased service resilience. However it was acknowledged by one water company that it would be very difficult to quantify these benefits.

3.18 Clifford Chance commented that the OFT could play a valuable role in filtering out avoidable references to the CC and allow businesses to more easily sequence transactions in order to avoid a mandatory reference. For instance , where the owner of one water company wishes to “trade up” or down by acquiring a different water company. If the OFT had power to accept Undertakings in Lieu, the complexity, costs and disruption of having a series of back to back transactions could be avoided.

3.19 Thames Water considered that sufficient protection for both Ofwat and customers was provided by the general merger regime. Thames said that the SMR had reduced capital market freedom to identify potential merger benefits and the automatic reference to the CC adds to the potential costs of any merger. This limits the information and evidence base available to directly answer the question and could be argued to impose a form of bias on the available evidence to answer the questions.

3.20 Dee Valley were interested to learn if the Mid Kent/South East Water merger had resulted in long term sustained benefits to customers in terms of reduced prices. This would be a direct indication of whether the merger had resulted in opex or capex savings.

3.21 Ofwat considered that the benefits would depend on a number of factors: the level of any new threshold and the number of mergers that would be exempt from the SMR; and whether those mergers would be caught under the normal merger regime and the type of remedies that might be imposed by that regime.

3.22 Ofwat accepted that evidence regarding the benefits associated with mergers is mixed. There could be benefits in relation to cost of capital savings and greater optimisation of water resources. As regards economies of scale and scope the evidence is far less conclusive and Ofwat considered that it was not currently possible to estimate the magnitude of savings.

Question 6. What are the likely costs of an increase in the threshold and permitting more mergers without a reference to the CC? Who is likely to bear these costs?

3.23 This question was only answered by seven respondents.

3.24 Severn Trent considered that an increase in the threshold to £70m would only exempt a further four companies and as these companies are typically not used as benchmark comparators there would be very little impact on the industry.

3.25 South Staffordshire considered that any benefits would exceed the costs and that they would return to customers at each Price Review. In any event, any potential costs could be offset by the introduction of a first stage test which would allow companies to propose remedies to mitigate against the loss of a comparator.

3.26 CCWater considered that there may be an eventual cost impact to customers as a result of the loss of a comparator through the weakening of Ofwat's ability to conduct cross-industry comparisons to benefit customers. However, they considered that this could be offset through alternative methods of comparison.

3.27 Ofwat stated that the loss of any comparator would result in a detriment to customers – fewer comparators weakens Ofwat's ability to make effective comparisons, not only in terms of setting efficiency targets but also in using league tables to challenge companies to improve. However, they recognised that the size of any detriment could be quite low depending on the merger. If the benefits exceed the detriment then the merger should be allowed to proceed assuming that some of the benefits are passed on to customers.

4. Feedback from workshops

4.1 Experts Workshop

Is the Special Merger regime still relevant – does Ofwat need to rely so heavily on comparators?

- Consensus was that SMR regime is still relevant – helps monitor efficiency and other benefits - pipes and infrastructure would continue to need comparators.
- Still a need to ensure adequate consumer protection.
- Comparators useful for different elements and scale of companies which makes it difficult to set an appropriate threshold.
- Complexity of the water sector means the range of comparators is perhaps more important than in other sectors.
- Only 10 comparators used in sewerage sector.
- Not clear what ideal number of comparators should be.
- The use of panel data is a possible alternative but Ofwat had recently introduced accounting separation. Totex (total cost modelling) could use much less data – could still do a lot with less comparators.

However:

- Comparative regulation delivering diminishing returns – needs to evolve to a more flexible process possibly with increased emphasis on international examples. But, incentive based regulation does not fail because of the incentives.

- Given the new lighter touch approach to economic regulation being considered by Ofwat, perhaps it was a bit early to make firm decisions on the future of comparators.
- Introduction of upstream competition may require greater comparative information requirements.
- We should consider the value of comparators relative to the next best alternative – would capital markets subject to regulation be better placed to decide?

Should the threshold be increased? What are benefits of increased merger activity?

- Consensus was “yes”, but differing views on by how much – some suggestions that it should be a small increase – possibly £25k-£35k.
- Little evidence apart from historical precedent to confirm that the SMR had constrained merger activity.
- Capital market pressure would incentivise companies to become more efficient or risk the threat of takeover.
- Potential for some economies of scale - cost of capital premium is lower for larger companies – increased buying power – reduced management costs.
- Rationalisation of network costs.
- Potential for economies of scope and better use of water resources in contiguous areas (e.g. the South East of England).
- But, what evidence is there to suggest that merged companies have become more efficient, reduced costs, improved in service and passed on benefits to their customers in the longer term?
- Is the merged company a better comparator?
- Could have undertakings requiring merged companies to retain separate data.

Should the threshold be increased to £70m? What are the benefits and the risks?

- There was no consensus on whether threshold should be increased to £70m.
- If threshold increased to £70m an additional 4 companies could merge (based on current ownership structures).
- Benefits mentioned were similar to previous question.
- Customers of merging companies may benefit from mergers at the expense of customers in other areas.
- The loss of a comparator will be greater if a merging company is near the frontier.
- Inefficient mergers might take place - potential for diseconomies of scale – there is written evidence that suggests diseconomies of scale above 400,000 connections in network industries.

Alternatives to setting a threshold? Applying regime to WaSCs only?

- Inconsistent with Cave recommendation with respect to promotion of capital market competition. Boundaries different, confusing for customers about whether subject to merger control. Send strange signal about policy intention.
- Do not want to specify the business model for a company (e.g. WaSCs are better than WoCs).

- Evolving policy in other sectors may influence future direction (e.g. Ofgem introducing SMR).
- Consider whether wider question around Ofwat's ability to regulate is actually the right question to ask.
- Applying test only to frontier companies would not be popular.
- Applying threshold to parts of the value chain could undermine aims of the Water White Paper by "spooking" investors (e.g. potentially lead to separation of retail, etc).

What are likely costs of allowing more mergers without reference to the CC? Who will bear those costs?

- Four further comparators (companies) potentially lost – not clear as regards consequences (where are they in terms of efficiency – frontier etc?). How does Ofwat use them?
- Inefficient mergers could take place and customers would bear the costs.
- The CC test should be broadened beyond simply the consideration of consumer interest. But likely to require legislation.

4.2 Water Company Workshop

- A higher threshold would give a signal that the water sector is becoming more like a normal market possibly leading to the removal of the SMR.
- Differing views on the number of comparators required by Ofwat.
- A smaller number of comparators could be better – Ofwat can always request information when it needs it.
- The value of comparators is dwindling but there is still value in retaining them.
- The loss of 4 comparators (i.e. those that are currently vulnerable to takeover because of their ownership model) would clearly be a loss to Ofwat and comparative regulation but not clear what benefits would be gained from the loss of 4 companies.
- Need to consider alternatives to a threshold.
- Only 10 comparators on the sewerage side but 64 different data points – to do the same for the water side would potentially increase the burden.
- Agreed that that the introduction of Bill reforms was the key to reducing uncertainty around mergers – greater transparency will reduce costs and potentially make mergers more attractive regardless of the threshold.
- Consider widening the regime such that OFT/CC consider Ofwat's ability to regulate rather than its ability to make comparisons.

- Guidance must be clear and transparent – it must ensure that stakeholder concerns are taken into account in developing an appropriate methodology. Should be a duty on Ofwat to consult with water companies on its proposed methodology, which is already provided for in the Bill.
- Could be beneficial to wait until PR14 is complete before taking any decisions on a revised threshold.

5. Next steps

5.1 We are still not convinced that sufficient evidence currently exists to support an increase in the threshold – very little new evidence emerged from the Call for Evidence or the Workshops on the costs and benefits of mergers which we could usefully use to produce an impact assessment to support an increase in the threshold. There also remains a degree of uncertainty as regards the future of comparative regulation with Ofwat proposing to move to a new regulatory model less dependent on comparators, and we therefore do not consider that now is an appropriate time to increase or abolish the £10m threshold.

5.2 Our preferred approach, which will be taken forward in the Water Bill, is the introduction of a first stage test which will require the OFT, in consultation with Ofwat, to decide whether a merger is likely to prejudice Ofwat's ability to make comparisons between companies before deciding whether to make a referral to the CC. The OFT will be able to accept undertakings from acquiring companies in lieu of a referral that would compensate for the loss of a comparator. The new Competition and Markets Authority (CMA)¹ will have a duty to keep the threshold under review.

5.3 Ofwat will be required to publish guidance and keep it under review on how it would assess the loss of a comparator. The guidance should set out the criteria to be used for assessing the effect of a merger and how a prospective merger might affect its ability to make comparisons between water companies (i.e. methodology, criteria, weightings etc). Ofwat will be required to consult various stakeholders including the OFT, the CC and water and sewerage companies before publishing or updating its guidance. This guidance will be used to inform water companies, the OFT and the CC about the potential cost of mergers as regards comparators and may include details and guidance on the types of undertakings/remedies that might be required to offset the loss of a comparator.

5.4 Under the first stage test the level of the threshold becomes irrelevant in that mergers in excess of Cave's proposed £70m threshold could be passed by the OFT (with reference to Ofwat's guidance) without referral to the CC. For example, a £70m threshold

¹ The Enterprise and Regulatory Reform Bill will create a new single Competition and Markets Authority (CMA) which will perform the functions of the CC as well as the competition functions and some of the consumer functions of the OFT.

will still result in an automatic referral for proposed mergers above this threshold. However, the first stage test will remove this automatic referral and incentivise companies to submit robust proposals based upon guidance by Ofwat on how the value of a comparator would be assessed.

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Any enquiries regarding this document/publication should be sent to us at: Nick Jenkins, Area 3C, Nobel House, 17 Smith Square, London, SW1P 3JR