Competition & Markets Authority

Water and sewerage mergers

Guidance on the CMA's procedure and assessment

13 November 2015
CMA49

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1. Introduction

Scope of the guidance

1.1 This guidance is concerned with the merger control regime for mergers involving two or more water and sewerage or water-only companies (either of which are referred to as 'water enterprises' in this guidance)[1] in England and Wales under the Water Industry Act 1991 (WIA) as amended by the Water Act 2014 (WA14).[2] Mergers between water enterprises (water mergers) are in certain circumstances subject to a special water merger regime. This guidance is concerned with the policies, procedure and methodology that the Competition and Markets Authority (CMA) will use in discharging its functions under the WIA.

1.2 This guidance should be read alongside other detailed guidance that the CMA has published or adopted in relation to merger control provisions of the Enterprise Act 2002 (EA02). This guidance cross-refers to other CMA guidance extensively and the CMA strongly recommends that merger parties make themselves familiar with these guides. Where this guidance is different from the CMA's other merger control guidance, this reflects the specific merger control regime applicable to water mergers and this guidance takes precedence.

1.3 This guidance replaces the previous CMA's guidance on water mergers.[3] While the CMA is not bound to follow the approach taken by the Competition Commission (CC) in water merger investigations, this guidance cites previous relevant CC decisions to illustrate how it will apply the provisions of the WIA.

1.4 This guidance does not consider any competition issues which might arise as a result of mergers involving water enterprises that the CMA may be investigating under the EA02. While the water and sewerage market is largely regulated and each water enterprise is a regional monopolist for water and/or waste water services, there are certain aspects of the market that are not subject to regulation, or have some degree of competition. If water enterprises with such activities have merged or will merge as part of a merger involving non-water enterprises as well as water enterprises, the CMA will consider the transaction, excluding the water enterprises, under the general merger

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[1] A water enterprise is an enterprise carried on by a company appointed under section 6 of the WIA to be a water and/or sewerage undertaker.

[2] The general merger regime (merger control provisions in the EA02) applies to water enterprises in Northern Ireland and Scotland. However, water merger parties in Northern Ireland must notify the Republic of Ireland Competition and Consumer Protection Commission if the overall turnover of the merging parties in Ireland exceeds €50 million, and the turnover of at least two of the parties in Ireland exceeds €3 million.

[3] *Water Merger References: Competition Commission Guidelines* (CC9), December 2004.

provisions of the EA02. If, in such a case, a merger is likely to give rise to competition issues, interested parties should refer to the CMA general merger guidance.[4] The CMA will consider these issues on a case-by-case basis, however, to minimise the burden on the parties, where a transaction is being considered under both the special water merger regime and the general merger regime, the CMA will endeavour to investigate the cases together.

1.5 For future water merger transactions that may give rise to competition issues, in line with the general merger regime, the CMA's informal advice procedure is available. For further advice on this procedure please see paragraphs 6.25 to 6.38 of the CMA general merger guidance *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2).

1.6 This guidance reflects the views of the CMA at the time of publication and may be revised from time to time to reflect changes in best practice, legislation and the results of experience, legal judgments and research. It may in due course be supplemented, revised or replaced. The CMA's webpages will always display the latest version of the guidance. Where there is any conflict, or difference in emphasis or detail between this guidance and other guidance produced or adopted by the CMA, the most recently published guidance takes precedence.

1.7 For merger cases that are referred for an in-depth phase 2 investigation, the final decision-making authority is an independent group of experts selected from a panel appointed by the Secretary of State (the inquiry group). Where this guidance is expressed to apply to the CMA's policy when making decisions at phase 1 whether to refer a merger for an in-depth phase 2 investigation, this does not bind the independent inquiry group when undertaking its assessment at phase 2.

Purpose of the special water merger regime

1.8 Under the EA02 the CMA has a general duty to review and obtain information related to mergers. Where the CMA believes that it is or may be the case that a merger qualifies as a relevant merger situation[5] and has resulted, or may be expected to result, in a substantial lessening of competition (SLC), it has a duty to refer it for an in-depth phase 2 investigation (the general merger regime). Mergers of two or more water enterprises are an exception this regime. In certain circumstances, the merger of two or more water enterprises

[4] For further information on competition issues please see the CMA's general merger guidance documents on our webpages.
[5] As defined by section 23(1) and (2) of the EA02.

is subject to a special merger regime which has been in place since the water industry was privatised in 1989 (the special water merger regime).

1.9 The intention of the special water merger regime is to ensure that a merger between two or more water or sewerage enterprises in England and Wales will not prejudice the Water Services Regulation Authority's (Ofwat) ability to make comparisons for the purpose of carrying out its statutory functions (such as setting price controls on regulated water enterprises and other regulatory functions).

1.10 The WIA (as amended) enables the CMA to clear a merger between two or more water enterprises in England and Wales (referred to in this guidance as a 'water merger') after a phase 1 investigation, either unconditionally or by accepting undertakings in lieu of a reference (UILs). The CMA must, during a phase 1 investigation, request and consider Ofwat's opinion on the water merger.[6]

1.11 The following chapters in this guidance document outline in more detail the policies, procedure and methodology used by the CMA to operate the special water merger regime.

Who does what?

1.12 The WIA assigns specific roles to the CMA and Ofwat in the special water merger regime during the phase 1 investigation process. The CMA is the UK's primary competition authority and is responsible for the merger control regime in the UK. However, under the WIA Ofwat has a statutory role in the phase 1 assessment of water mergers. The following section provides a brief overview of how these roles interrelate and the role of the European Commission (the Commission).

Role of the CMA

1.13 In line with the general mergers regime the WIA provides for a two stage process for water mergers. The CMA has a duty to refer a water merger for an in-depth phase 2 investigation (a phase 2 reference) unless the CMA believes that:

[6] From 2004 to November 2015 the CMA had a mandatory duty to refer any water mergers for a phase 2 investigation provided that: the anticipated or completed arrangements will result or have resulted in a merger of two or more water enterprises; and the turnover of the water enterprises being taken over, or of those already belonging to the acquirer, each is greater than £10 million.

(a) the merger arrangements for anticipated mergers are not sufficiently advanced or are unlikely to proceed;

(b) the merger is not likely to prejudice Ofwat's ability, in carrying out its functions, to make comparisons between water enterprises; and

(c) the merger is likely to prejudice Ofwat's ability to make comparisons, but the prejudice is outweighed by relevant customer benefits (RCBs).

1.14 Before the CMA makes a decision on whether there is a duty to refer it must request and consider Ofwat’s opinion on considerations *(b)* and *(c)* above. See paragraphs 1.18 to 1.23 on Ofwat’s role.

1.15 The WIA also gives the CMA the power to accept UILs of a phase 2 reference in relation to water mergers, as it can with general mergers. In relation to water mergers the UILs must remedy, mitigate or prevent the merger’s prejudicial effect on Ofwat’s ability to make comparisons.[7] When considering whether to accept UILs the CMA must request and consider Ofwat’s opinion on the effect of the undertakings offered.

1.16 Where the CMA refers the merger for an in-depth phase 2 investigation, it conducts a more detailed analysis and the inquiry group must decide:

- whether a water merger has been created or will be created;
- whether the water merger has prejudiced, or may be expected to prejudice, the ability of Ofwat to make comparisons between water enterprises; and
- where there is a prejudicial outcome, on the appropriate remedy.[8]

1.17 The inquiry group are an independent group of experts and are the final decision makers in phase 2.

Role of Ofwat

1.18 Ofwat is the independent economic regulator for water and sewerage services in England and Wales. Water enterprises are regional monopolies and are regulated by Ofwat in line with its statutory duties, in particular to further the customer objective, to secure that water companies carry out their functions and are able to finance their activities (and long-term resilience for England

[7] Before the CMA decides whether or not to accept UILs, it will request and consider Ofwat’s opinion on the effect of the UILs. See section 33D(6) WIA.
[8] This may include behavioural, intellectual property and/or divestiture remedies.

water companies).[9] Ofwat compares information between water companies to regulate prices, identify good performance to incentivise best practice, and set incentives for water companies to improve their quality of service.

1.19 Before the CMA forms a view on whether or not to refer a water merger for a phase 2 investigation the CMA must request and Ofwat must give its opinion on:

- the impact of the merger on its ability to make comparisons between water enterprises; and
- where Ofwat forms the view that the merger is likely to prejudice its ability to make comparisons, whether this prejudice is outweighed by the RCBs of the merger.

1.20 When forming its opinion on these points, Ofwat must apply the methods set out in its statement of methods.[10] The statement of methods sets out the criteria it will use in its assessment of the effect of the merger on its ability to make comparisons, and the relevant weight that it will place on each criterion.[11]

1.21 Where merger parties have offered UILs, the CMA must request and Ofwat must give its opinion on the effect of the UILs offered. The CMA must consider Ofwat's opinion.

1.22 Detailed information on Ofwat's approach to water mergers and its statement of method is provided in its publication: *Consultation on Ofwat's approach to future mergers and statement of method.*[12]

1.23 Ofwat does not have a statutory role in a CMA phase 2 investigation and the final decision on whether to allow the merger to proceed is made by the inquiry group. Based on past experience from the CC's and the CMA's phase 2 investigations, the CMA expects that Ofwat's views and submissions will play an important role in those investigations.[13]

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[9] Section 2 of WIA.
[10] Section 33B(2) of WIA.
[11] Section 33C of WIA.
[12] See Ofwat (2015), *Consultation on Ofwat's approach to future mergers and statement of method*.
[13] The CMA took over a number of functions formally performed by the Office of Fair Trading and the CC when it was formed on 1 April 2014. The CC was previously responsible for conducting phase 2 investigations, including those involving water enterprises.

The European Union Merger Regulation

1.24 The Commission has jurisdiction over all mergers, including those between water enterprises, which have an ‘EU dimension’ as defined in the European Union Merger Regulation (EU Merger Regulation).[14] Mergers have an EU dimension where they satisfy one of two alternative sets of jurisdictional thresholds:

(a) either:

(i) the combined aggregate worldwide turnover of all the undertakings concerned is more than €5 billion; and

(ii) the aggregate EU-wide turnover of each of at least two of those undertakings is more than €250 million;

(b) or:

(i) the combined aggregate worldwide turnover of all the undertakings concerned is more than €2.5 billion; and

(ii) in each of at least three member states, the combined aggregate turnover of all those undertakings is more than €100 million; and

(iii) in each of at least three of the member states included for the purposes above, the aggregate turnover of each of at least two of the undertakings concerned is more than €25 million; and

(iv) the aggregate EU-wide turnover of at least two of the undertakings concerned is more than €100 million;

(c) unless in relation to either situation above, each of the undertakings concerned achieves more than two-thirds of its aggregate EU-wide turnover within one and the same member state.

1.25 Those mergers that satisfy one of these two sets of jurisdictional thresholds must be notified to, and cleared by the Commission prior to their implementation, which is, in essence, prior to the merger being completed. There is no specific deadline within which a merger must be notified to the Commission.

1.26 There are a number of circumstances in which a merger falling within the Commission’s jurisdiction may be referred to the CMA for investigation by the

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[14] Council Regulation (EC) No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ 2004 L24/1, Articles 1 and 3. See further CMA2, Chapter 18.

Commission. For example, a case may be referred by virtue of either Article 4(4) or Article 9 of the EU Merger Regulation, on the basis that the main competition issues of the merger are limited to the UK.[15]

1.27 In addition, a national authority (in the UK, the Secretary of State) may take appropriate action to protect legitimate interests where they would be impacted by a merger with an EU dimension.[16] As a result a merger may be referred to the CMA (in part or in its entirety) for investigation on public interest grounds. Any competition aspects of the merger will in that situation continue to be investigated by the Commission.

1.28 In 1995 the Commission published a decision recognising the legitimate interest of the UK in applying a special water merger regime.[17] This decision was taken in the context of the takeover by Lyonnaise des Eaux SA of Northumbrian Water Group plc. The UK authorities conducted their assessment on the public interest aspects of the merger[18] and the wider competition aspects of the merger were reserved for the Commission. This guidance takes into account this approach taken by the Commission in that case.

1.29 Given the flexibility in allocation between the CMA and the Commission for mergers with an EU dimension the CMA would encourage merger parties to keep the CMA and Ofwat informed of any intention to notify to the Commission.

1.30 For more information about the time limits and procedures for those mergers with an EU dimension see CMA2, Chapters 16 and 18.

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[15] See CMA2 for further guidance.
[16] Article 21(4) of the EU Merger Regulation limits the legitimate interests on the basis of which the Secretary of State may intervene to public security, plurality of the media and prudential rules. Further, Article 21(4) allows EU member states to communicate other public interests to the Commission, which may recognise these after an assessment of their compatibility with the general principles and other provisions of EU law.
[17] Case M.567, Lyonnaise des Eaux/Northumbrian Water, Commission decision of 21 December 1995. The Commission took this decision under Article 21(3) of Regulation (EEC) 4064/89, the forerunner of the current EU Merger Regulation, which for these purposes is similar to Article 21(4) of the EU Merger Regulation. The Commission also noted that a new application for recognition of the UK's legitimate interest would be necessary should any amendment be made to the regulatory legislation.
[18] Lyonnaise des Eaux SA and Northumbrian Water Group PLC report (1995) by the Monopolies and Mergers Commission (the forerunner of the CC).

2. The legal framework

Introduction

2.1 The following chapter provides an overview of the statutory questions the CMA is required to answer in relation to water mergers.

Statutory questions

2.2 The WIA imposes a duty on the CMA to refer completed and anticipated water mergers for an in-depth phase 2 investigation unless the CMA believes that:

(a) for anticipated mergers, the arrangements are not sufficiently far advanced or not sufficiently likely to proceed to justify a reference;

(b) the water merger has not prejudiced, or is not likely to prejudice, Ofwat's ability in carrying out its functions to use comparative regulation; or

(c) the water merger has prejudiced, or is likely to prejudice, Ofwat's ability to make comparisons between water enterprises, but that this prejudice is outweighed by RCBs relating to the merger.[19]

2.3 Before forming a view about the exceptions set out at *(b)* and *(c)*, the CMA must request and consider Ofwat's opinion about both the likely prejudice and whether such prejudice is outweighed by RCBs.[20] In view of the two-phase structure of the merger control regime, the CMA considers that for the purposes of the exception in (b) its duty to refer will apply if it believes that there is a realistic prospect of prejudice to Ofwat's ability to make comparisons between water enterprises resulting from the water merger.

2.4 Where the CMA is under a duty to refer a water merger for a phase 2 investigation it may accept UILs to remedy, mitigate or prevent the merger's prejudicial effect on Ofwat's ability to make comparisons between water enterprises.[21] When forming a view on UILs the CMA must consider the need to achieve as comprehensive a solution to that effect on Ofwat as is reasonable and practicable. Moreover, the CMA must request and consider Ofwat's opinion on the effect of the offered UILs.

2.5 Following a reference for a phase 2 investigation, the inquiry group must:

[19] Sections 32 and 33A(1) of WIA.
[20] Section 33A(3) of WIA.
[21] Section 33D of WIA.

(a) confirm that a water merger has taken place or that arrangements are in progress which, if carried into effect, will result in a water merger; and

(b) determine whether the water merger has prejudiced, or may be expected to prejudice, the Ofwat's ability to make comparisons between different water enterprises.[22]

2.6 If the inquiry group decides that there is a prejudicial outcome, it must decide the following additional questions:

(a) whether the CMA should take action for the purpose of remedying, mitigating or preventing the prejudice or any adverse effect that has resulted, or may be expected to result, from this prejudice;

(b) whether the CMA should recommend the taking of action by others for this purpose; and

(c) in either case, what action should be taken and what is to be remedied, mitigated or prevented.[23]

2.7 In deciding whether action should be taken and, if so, what action, the inquiry group may in particular have regard to the effect of any such action on any RCBs in relation to the merger, provided that this would not prevent a solution to the prejudice concerned or the benefits are substantially more important than the prejudice.[24,25]

Jurisdiction

2.8 The CMA has jurisdiction to examine a water merger under the special water merger regime where:

- arrangements are in progress which, if carried into effect, will result in a merger of any two or more water enterprises (anticipated merger), or that such a merger has taken place;[26]

- the turnover of the water enterprise being taken over, and at least one of the water enterprises already belonging to the person making the takeover, are greater than £10 million (the turnover test);[27] and

[22] Sections 35(1) and 36(1) of EA02 as modified by regulation 11 of the Water Mergers (Modification of Enactments) Regulations 2004 (SI 2004/3202) (the Water Mergers Regulations).
[23] Sections 35(5) and 36(4) of EA02 as modified by regulation 11 of the Water Mergers Regulations.
[24] Further discussion on RCBs can be found in Chapter 6.
[25] Sections 35(7) and 36(6) of EA02 as modified by regulation 11 of the Water Mergers Regulations.
[26] Section 32 of WIA.
[27] Section 33 of WIA.

- where the merger has taken place, the merger completed not more than four months before the reference for a phase 2 investigation, unless completion took place without this having been made public and without the CMA being informed of it.[28]

The merger of two or more water enterprises

2.9 To establish if the transaction will result or has resulted in a merger of two or more water enterprises the CMA must determine if the merger parties are water enterprises. Both parties (or where the merger is between more than two parties, at least two of those parties) must be water enterprises for the special water merger regime to apply. Where only one party is a water enterprise the transaction will be assessed under the EA02 and follow the general merger regime.

2.10 The CMA must also determine whether the water enterprises will cease or have ceased to be distinct. This concept has the same meaning as in the general merger regime, and hence the CMA must identify whether the water enterprises are being brought under common ownership or control.[29] Further guidance on this concept can be found in Chapter 4 of CMA2.

The turnover test

2.11 For water mergers the CMA cannot make a reference for a phase 2 investigation where the value of the turnover of the water enterprises being taken over, or already belonging to the acquirer, are each less than £10 million.[30]

2.12 The jurisdictional test is based on turnover only. This differs from the general merger regime where mergers may qualify for investigation based on a turnover test or a share of supply test.[31]

2.13 The relevant turnover is limited to the provision of services as a water or water and sewerage company, ie the 'regulated' turnover. Consequently, any turnover attributed to other services/products, offered by the water company

[28] Section 24 of EA02 as modified by regulation 4 of the Water Mergers Regulations.
[29] Section 35(2) of WIA and section 26 of EA02.
[30] Section 33 of WIA.
[31] The share of supply test is where the enterprises that cease to be distinct supply or acquire goods or services of any description and, after the merger, together supply or acquire at least 25% of all those particular goods or services of that kind supplied in the UK or in a substantial part of it. The merger must also result in an increment to the share of supply or acquisition.

other than water and sewerage services, should be excluded from the calculation of the relevant turnover for the purposes of the turnover test.[32]

2.14 The WIA also places a duty on the CMA to keep the thresholds for the turnover test in water mergers under review and periodically advise the Secretary of State on whether such thresholds are still appropriate.[33]

Time limits for reference decisions

2.15 After starting an investigation, the CMA is required to decide within a timetable of 40 working days whether its duty to refer is met. As in the general merger regime, this timetable starts on the first working day after the CMA confirms to the merger parties that it has received sufficient information to enable it to begin its investigation.[34]

2.16 In addition, as in the general merger regime, for the CMA to be able to refer a completed merger, the reference must take place within four months from the date of completion or, where completion was not made public and the CMA was not informed of it, within four months from the earlier of the time that material facts are made public or the time the CMA is told of material facts.[35] Further guidance on this concept can be found in paragraphs 4.42 to 4.46 of CMA2.

Merger fees

2.17 Subject to some limited exceptions, any water merger where the CMA reaches a decision on whether or not to refer the merger for a phase 2 investigation. This fee is applicable irrespective of whether a reference is made.[36]

2.18 The merger fee for water mergers is currently calculated by reference to the value of the turnover in England and Wales of the water enterprise being taken over and is payable to the CMA when the decision on whether or not to

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[32] Section 33(4) WIA states that the applicable turnover is calculated in accordance with the provisions specified in regulations published by the Secretary of State (The Water Mergers Determination of Turnover Regulations, SI 2004/3206), and Schedule of the SI 2004/3206. Paragraph 3 of the Schedule, the applicable turnover of a water enterprise ‘shall be limited to the amounts derived from the sale of products and the provision of services falling within the appointed business of the water enterprise to businesses or consumers in England and Wales after deduction of sales rebates, value added tax and other taxes directly related to turnover’.
[33] Section 33(6A) of WIA.
[34] SI [to be confirmed]/2015. The regulations will come into force on [date to be confirmed] 2015.
[35] Section 24 of EA02 as modified by regulation 4 of the Water Mergers Regulations.
[36] [To be confirmed by Defra] Full details in respect of the payment of fees are, pursuant to section 121 of the, EA02 (Merger Fees and Determination of Turnover) Order [to be confirmed] (as amended [to be confirmed]).

refer the merger for a phase 2 investigation is announced. The bands for this fee are, as for other mergers, as follows:

- £40,000 where the value of the UK turnover of the enterprise being acquired is £20 million or less.
- £80,000 where the value of the UK turnover of the enterprise being acquired is over £20 million but less than £70 million.
- £120,000 where the value of the UK turnover of the enterprise being acquired is over £70 million but less than £120 million.
- £160,000 where the value of the UK turnover of the enterprise being acquired is over £120 million.

2.19 For further information on merger fees please see Merger fees payment information on the CMA webpages and paragraphs 20.1 to 20.7 of CMA2.

3. The merger process

Introduction

3.1 This chapter of the guidance provides more detail on certain aspects of the phase 1 and phase 2 water merger process. Annex A provides an overview of the principal stages and timings in a phase 1 and a phase 2 investigation. Annex B outlines the key interactions between the CMA and Ofwat in the phase 1 investigation.

Phase 1 process

Notifying water mergers

3.2 The UK merger regime is a voluntary notification regime. This means that there is no legal requirement to notify the CMA of a water merger even if it meets the jurisdictional threshold. However the CMA keeps merger activity under review and it may investigate mergers on its own initiative if a merger has not been notified.[37]

3.3 Where the CMA learns of a water merger, it may decide to send merger parties an enquiry letter requesting information about the transaction, in particular, to understand if the jurisdiction thresholds have been met. Once the CMA is satisfied that the information it has received in response to its enquiry letter is complete, and if it appears that the jurisdictional threshold is met, it will, if appropriate, commence its investigation.

3.4 Where merger parties have decided to make a voluntary notification to the CMA of the water merger, they are encouraged to enter into pre-notification discussions with the CMA and Ofwat.[38]

Information exchange between the CMA and Ofwat

3.5 To minimise the burden on merger parties, where appropriate, Ofwat and the CMA will coordinate information requests. The CMA will request a waiver from the merger parties to allow disclosure of information to Ofwat. The CMA expects that the merger parties will work closely and openly with both itself and Ofwat throughout the entire phase 1 and phase 2 processes including any UIL process.

[37] Further information can be found in CMA2, in particular paragraphs 6.5–6.21 and 6.59 & 6.60.
[38] Further information can be found in CMA2, in particular paragraphs 6.39–6.58.

3.6 Sharing of information (including data) between the CMA and Ofwat is crucial for the effective fulfilment of their respective duties under the special water merger regime and should reduce the burden on merger parties that could otherwise arise, for example from duplicative information requests. The CMA and Ofwat may, where appropriate, discuss with each other water merger issues that the merging parties bring to their attention; informal advice they will be providing or have provided; pre-notification drafts; and information obtained throughout the phase 1 investigation.

3.7 Any disclosure of information between the CMA and Ofwat, and any use by the recipient of such information, shall only be to the extent permitted by law, including by reference to the provisions of Part 9 of the EA02 and to section 206 of the WIA.[39]

Pre-notification

3.8 In line with the general merger regime the 40 working day timetable will not start until the CMA has confirmed it has sufficient information to start its investigation. In the case of water mergers, this will include the information Ofwat requires, in the form of a merger impact assessment submission, to start its assessment of the merger required for the purpose of providing its opinion to the CMA.[40] Merger parties should allow sufficient time in their planning for this and should approach Ofwat at the earliest opportunity to start this process.

3.9 In addition to working with Ofwat before making a voluntary notification to the CMA, merger parties are strongly encouraged to discuss the merger and the notification with the CMA.

3.10 Pre-notification can benefit both the merger parties and the CMA in a number of ways. For example:

- The water and sewerage sector is complex and features a high degree of specialised regulation. Pre-notification discussions can help the CMA case team better understand those issues and provide more time for the case team to develop their understanding of the sector.

- Discussions in advance can be used to clarify the information that the CMA and Ofwat require from the merger parties in order to start the

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[39] For further information about information sharing between the CMA and Ofwat please see *Statement of intent: An agreement on the working arrangements between the CMA and Ofwat for the special water merger regime* (the statement of intent).

[40] For further information on the merger impact assessment submission, see Ofwat (2015), *Ofwat's approach to mergers and statement of methods*.

investigation. This can help reduce the amount of information that is provided at notification and streamline subsequent information requests to the merger parties during the investigation.

- The CMA is not able to stop the clock once the water merger investigation has started to allow a more in-depth consideration of any complex issues or particularly large volumes of new information, except in some limited circumstances where information from the parties remains outstanding. More detailed pre-notification discussions maximise the opportunity the CMA and Ofwat have to consider the impact on Ofwat's ability to use comparative regulation and therefore the appropriateness of a decision that an exception to the duty to refer applies.

- In certain cases it may be appropriate to discuss potential UILs during pre-notification, particularly where the merger parties acknowledge that the merger may prejudice Ofwat's ability to use comparative regulation.

3.11 For further information on the benefits of pre-notification, please see CMA2*,* Chapter 5, paragraphs 6.39 to 6.43.

3.12 The CMA will not make any pre-notification discussions public. However, during this period and throughout the investigation information may be shared between Ofwat and the CMA. Please see paragraph 3.5 to 3.7 above, and the statement of intent.

Fast track reference cases

3.13 In some circumstances the CMA may accelerate a case to a phase 2 investigation where there is sufficient evidence of an adverse impact on Ofwat's ability to make comparisons for a reference and where this reflects the wishes of the merger parties.

3.14 For a case to be fast-tracked the CMA must have evidence in its possession at an early stage of the investigation that it believes that the test for a reference to phase 2 is met and the notifying parties must have requested and given consent for the use of the procedure. For more information about fast track references please see CMA2*,* Chapter 6, paragraphs 6.61 to 6.65.

Water merger assessment

3.15 A detailed discussion of the CMA's phase 1 merger assessment process in the general merger regime is in CMA2. This discussion also applies to water mergers except as set out below.

3.16 The assessment phase starts by the CMA issuing notice of commencement of the case on its webpages. An 'invitation to comment' to invite interested third parties to submit their views to the CMA on the transaction will also be issued around that time. The CMA will also contact and interact with third parties directly to obtain their views on the merger, this may include other governmental bodies, industry, customer and consumer groups, to understand their views and request evidence to support them.

3.17 The CMA will liaise closely with both the merger parties and Ofwat during the lifetime of the case. The CMA will take account of the evidence provided by these third parties, including the merger parties and Ofwat, when forming its decision on the merger.

3.18 There may be a need for additional or more comprehensive information from merger parties beyond what is provided to the CMA in order to start its investigation.[41] Where the CMA identifies a need for further information it will ask for the data, information or documents as soon as it is clear that they are necessary.

3.19 CMA has 40 working days to complete the initial phase 1 process.[42] Ofwat and the CMA will work closely together throughout the phase 1 investigation.[43] Ofwat has a statutory role in phase 1 to provide the CMA with its opinion at key stages of the investigation. A table in Annex B lists the principal stages in phase 1 and an overview of the responsibilities of Ofwat and the CMA at each stage. Ofwat will input into the merger process at the following stages:

- **Pre-notification**: The CMA expects that the merger parties will engage with both Ofwat and the CMA during pre-notification.

- **Day 1:** The CMA will not start the investigation until it has sufficient information and Ofwat has the necessary information it requires to carry out its assessment.

- **No later than day 15:** Before the CMA's internal state of play meeting, Ofwat will provide the CMA with its draft opinion on whether the merger has prejudiced or is likely to prejudice its ability to make comparisons and

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[41] The CMA has the power under section 109 of the EA02 to issue a notice to require a person to provide information and documents or to give evidence. However, the CMA is likely to request information informally where possible. Section 109 of the EA02 applies to the CMA's investigations of water mergers in both phase 1 and phase 2 pursuant to regulation 30 of the Water Mergers Regulations and paragraph 22(19) of Schedule 1 to the Enterprise and Regulatory Reform Act 2013 (Competition) (Consequential, Transitional and Saving Provisions) (No. 2) Order 2014 (SI 2014/549).
[42] SI [to be confirmed]/2015.
[43] For information on how the CMA and Ofwat will work together in practice, see the statement of intent.

its view of whether any such prejudice is outweighed by any RCBs of the merger.[44]

- **No earlier than day 25:** If the CMA decides to hold a case review meeting,[45] Ofwat will attend the issues meeting with the merger parties and will submit its final opinion to the CMA no later than two working days before the CMA sends the issues letter to the merger parties. Ofwat and the CMA will discuss the issues letter before it is sent to the parties.[46] The merger parties will be sent a non-confidential version of Ofwat's opinion with the issues letter.

- **By day 40:** The CMA will decide whether to refer the water merger for a phase 2 investigation and provide the reasons for its decision to the merger parties. The full non-confidential decision will be published on the CMA's webpages at a later date. Unless otherwise agreed with the CMA, Ofwat will not publish its opinion or comment on the merger until after the CMA has published its full non-confidential decision. See paragraph 3.23 below for further information.

3.20 If the CMA finds that it is under a duty to refer the merger for a phase 2 investigation the merger parties have an opportunity to avoid this outcome by offering the CMA UILs at phase 1. The CMA cannot impose remedies on the merger parties at phase 1.

3.21 Merger parties can discuss potential UILs with the case team or decide to offer UILs at any stage of the phase 1 investigation. The statutory framework means that the CMA will only formally consider UILs after a decision has been taken. Notwithstanding this, the CMA strongly recommends that where merger parties believe a merger has the potential to raise concerns they consider possible UILs during pre-notification and in the early stages of the investigation and discuss these with the CMA case team and Ofwat. These discussions can help merger parties to identify if the UILs being discussed might be suitable to address any concerns. These early discussions also help to ensure that if the CMA reaches a decision to provisionally refer the case for a phase 2 investigation the merger parties will be able to formally propose UILs quickly and maximise the chances of the UILs being accepted.[47]

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[44] This is no later than 15 working days after the investigation has started.
[45] See CMA2, paragraphs 7.34–7.49.
[46] In line with the general merger regime, while the CMA will interact with third parties, in light of the short timescales of a phase 1 investigation and the confidentiality constraints, it is not CMA practice to provide third parties with an opportunity to comment on the issues letter provided to the merger parties.
[47] For further information see CMA2, Chapter 8, paragraphs 8.7–8.9.

3.22 The latest the parties can offer such UILs is five working days after receiving the CMA's reasons for its decision that the duty to refer is met.[48] Where the parties make such an offer, the CMA must decide within ten days of the decision, taking account of Ofwat's views, whether there are reasonable grounds for believing that the UILs offer or a modified version of them might be accepted by the CMA. If so, the CMA must reach a final decision on acceptance of the UILs within 50 working days from the date of the parties' receipt of the CMA's decision that the duty to refer is met. The CMA can extend this period by a further 40 working days if it considers there are special reasons for doing so.[49] The CMA strongly encourages merger parties to discuss possible UILs as soon as possible after they receive the CMA's reasoned decision. The high-level process and indicative timings following the receipt of the duty to refer decision are:

- **UILs day 0-5**: During the five-day period that the parties have to offer UILs following receipt of the CMA's decision Ofwat may attend meetings or calls with the CMA and merger parties on UILs.

- **UILs by day 9**: Ofwat submits its provisional view on the UILs offered to the CMA by the ninth day following the CMA's decision.

- **UILs by day 10:** The CMA considers Ofwat's view and the evidence submitted by the merger parties and decides whether there are reasonable grounds for believing that the UILs offered (or a modified version of them) might be accepted by the tenth day following the CMA's decision.

- **UILs consultation:** Where merger parties offer UILs, and the CMA considers that these might be suitable, the CMA will invite comments from third parties on the UILs before its final acceptance of any such UILs. If the CMA decides to consult on the UILs offered Ofwat will give detailed consideration to the UILs offered and submits its final opinion to the CMA two days before the start of the consultation.

- **UILs by day 50:** After the public consultation the CMA decides whether or not to accept the UILs offered and publishes its decision.

Publication

3.23 By working day 40 of the phase 1 investigation the CMA is required to publish a notice of its decision and provide the reasons for its decision to the merger

[48] SI[to be confirmed]/2015.
[49] For further information see CMA2, Chapter 8, paragraphs 8.23–8.26.

parties.[50] In some cases this is accompanied by a press release. Following discussions with the merger parties and Ofwat a non-confidential version of the full CMA decision will be published at a later date. Ofwat will provide the CMA with a confidential version of its opinion for the purpose of the CMA's decision on the merger. For publication purposes, the CMA may request Ofwat to provide it with a non-confidential version of its opinion.

3.24 A link to the CMA's and Ofwat's publications related to the merger will be provided on each organisation's respective websites.

Phase 2 process

3.25 If the CMA refers a water merger for a phase 2 investigation, in line with the general merger regime the CMA has 24 weeks for this investigation. This may be extended by up to eight weeks if it considers that there are special reasons why a report cannot be prepared and published within the deadline.[51] A diagram outlining the process and the expected timelines that apply to general mergers can be found in Annex A.

3.26 All the CMA's functions in a phase 2 investigation are carried out by inquiry groups and they are the decision makers for the water merger. Their role is to set the direction of the inquiry, review the evidence and analysis, and answer the statutory questions (which are outlined in paragraphs 2.5 to 2.7 above). The inquiry groups are supported by a CMA case team.

3.27 In contrast to a phase 1 investigation, Ofwat does not have a statutory role in a phase 2 merger. However, it is likely that the CMA will continue to work closely with Ofwat throughout a phase 2 investigation.

3.28 The process for phase 2 water merger investigations will follow the same procedure as general merger investigations. For more information about the phase 2 process and procedure see Chapters 10 to 14 of CMA2.

[50] See further CMA2, Chapter 9.
[51] Section 39(3) of EA02, which applies to water mergers pursuant to paragraph 1 of Schedule 4ZA of WIA.

4. Analytical approach and methodologies

Introduction

4.1 The question of substance that the CMA has to consider in its decision on water mergers is whether the merger may prejudice Ofwat's ability to make comparisons between water enterprises, and if so, to what extent. The basic analytical framework on this question applies across both phases 1 and 2 of the CMA's investigation.

4.2 There are different legal tests that apply at phase 1 and phase 2 and as a consequence of this, there are different evidential thresholds on prejudice between the two phases. The question for the CMA at phase 1 is whether the merger is **not likely to** prejudice Ofwat's ability to make comparisons between water enterprises. At phase 2 the question for the CMA is whether the merger **has or may be expected to** prejudice Ofwat's ability to make comparisons. Given these different legal tests, and the time constraints, the amount and complexity of analysis conducted by the CMA is likely to differ between the two phases.

4.3 The section below explains briefly the main areas where Ofwat makes comparisons, and the factors that the CMA may take into account in its assessment of prejudice, which make reference to Ofwat's statement of method.[52]

Use of comparators by Ofwat

4.4 Ofwat is responsible for the economic regulation of the water sector in England and Wales. The WIA imposes duties and confers powers on Ofwat to regulate water enterprises in line with its statutory objectives, in particular to further customer interests, and to secure that water enterprises can carry out their functions and are able to finance their activities. Other duties include promoting efficiency and contributing to sustainable development.

4.5 As each water enterprise is effectively a regional monopoly, comparative regulation has underpinned the way Ofwat has regulated the water and sewerage sector since privatisation in 1989. Ofwat uses comparisons both during the price review process, for example in setting price limits or service quality requirements, and between price reviews, for monitoring and enforcement, and spreading best practice.

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[52] See also Ofwat (2015), *Ofwat's approach to mergers and statement of methods*.

4.6 One of Ofwat's primary functions is to set price control limits, which determine the amount of revenue water enterprises can receive during the subsequent price control period. Ofwat sets these limits for a five-year period following a price review, the latest of which (PR14) set revenues for the period 2015 to 2020. The price control protects customers from excessive prices, while incentivising companies to make efficiency improvements, and enables efficient companies to finance their activities.

4.7 Ofwat's determination of revenue limits requires (among other things) identifying the level of allowed expenditure (costs). For example, at PR14 Ofwat set separate price controls for wholesale and retail activities, meaning separate assessments of wholesale water, wholesale wastewater, non-household retail and household retail costs were made. It used comparisons between companies for each price control to maximise the information available to it on likely future costs and to identify an efficient expenditure allowance. Comparisons help it overcome issues of imperfect and asymmetric information, to better allow it and other stakeholders to assess company performance.

4.8 Within the wholesale price control process Ofwat uses econometric modelling and other benchmarking approaches to determine the level of efficient costs.[53] This comparative approach can improve cost estimation, as Ofwat is better able to assess the true costs of water enterprises by comparing costs across a number of independent firms operating in similar circumstances, and to control for differences between companies. The number and quality of comparators is of particular importance to econometric modelling since its statistical robustness depends on the number, independence, and degree of variation of observations. Comparisons between companies can also be used to consider special factor claims for areas not otherwise covered in the cost assessment. To ensure that identified cost thresholds represented reasonably efficient costs, at PR14 Ofwat adjusted the costs forecast by its models to reflect upper quartile performance, thereby using comparators for benchmarking purposes.

4.9 As well as its econometric modelling, Ofwat typically uses comparisons between companies in a range of other ways in determining price controls. For example, at PR14 comparisons were used in:

[53] At PR14 Ofwat used a range of econometric models and unit cost models to determine wholesale cost allowances for water and wastewater, which were assessed separately. For water, it used econometric models to assess total expenditure (totex) using panel data from 18 companies over a five-year period. For wastewater, it used econometric models to assess base expenditure (for ten companies over seven years) and unit cost models to assess enhancement expenditure.

- assessment of household retail price limits;
- cost of capital and financeability; and
- business planning processes.

4.10 Ofwat also uses comparisons to monitor and incentivise performance and service quality. For example:

(a) As part of PR14 Ofwat conducted comparative analysis of companies' performance commitment and outcome delivery incentive proposals, covering aspects such as: duration of supply interruptions; number of contacts from customers regarding quality of water; number of sewerage pollution incidents; and leakages.

(b) Ofwat has in recent price controls set a service incentive mechanism, which comprises quantitative and qualitative components that measure customers' overall satisfaction with service levels. Companies are rewarded or penalised financially for their performance relative to the rest of the industry.

4.11 The CMA notes that beyond the use of comparators at periodic price reviews, Ofwat also makes comparisons between approaches taken by different companies to aid ongoing activities in relation to monitoring and enforcement activities, and to spread best practice. Examples of Ofwat's use of comparators in these areas include its review of companies' approaches to: board leadership and transparency; social tariffs; customer redress; and claims for interim changes in price limits during a control period.

4.12 Ofwat's approach to regulation and therefore how it uses comparators may change in future in response to developments in the sector. For example, the introduction of non-household retail competition may affect the use of comparisons to assess elements of the non-household control. Cost to serve benchmarks used by Ofwat in its retail price controls may also change in future. The CMA will have regard to foreseeable prospective changes in the use of comparators in its assessment of prejudice, in particular as Ofwat proceeds in developing its approach to the next price review.

Impact of a merger on Ofwat's ability to make comparisons

4.13 The CMA considers that an increase in common ownership or control across one or more companies has the potential to affect the ability of Ofwat to make comparisons. A merger may have an adverse impact on Ofwat's ability to:

(a) set price controls (whether at the wholesale or retail level);

(*b*) monitor and incentivise service quality; and

(*c*) use comparisons to carry out ongoing monitoring and enforcement activities, and to identify and spread best practice.

4.14 The loss of a comparator resulting from a merger could affect Ofwat's ability to make comparisons in a number of ways:

(*a*) It may remove a high performing company from Ofwat's set of comparators, which could impact on regulatory benchmarks used by Ofwat and reduce the scale of the efficiency challenge to the wider industry.

(*b*) It would reduce the number of independent observations in Ofwat's econometric and other models, and consequently could reduce the precision of those estimates or their susceptibility to outliers. To the extent that Ofwat can place less reliance on efficiency comparisons, water companies may expect future price caps to be based to a greater extent on factors related to their own costs and to a lesser extent on factors independent of their own costs, and consequently may have less incentive to achieve costs savings.

(*c*) It may remove companies with important similarities or differences to other companies, where these aspects can be valuable in making comparisons between companies or in identifying best practice or the use of innovative approaches.

4.15 Some examples of the type of factors that the CMA will consider (consistent with Ofwat's statement of methods) when assessing the impact of the merger on the value of Ofwat's comparisons are listed below and discussed further in paragraphs 4.16 to 4.22. These factors are:

- the extent to which the merger involves overlaps (discussed in paragraph 4.16);
- whether the merger involves the loss of an independent comparator (discussed in paragraph 4.17);
- the extent to which the merger will change benchmarks (discussed in paragraph 4.18);
- the number and quality of independent observations that remain (discussed in paragraph 4.19);

- whether the merger leads to the loss of a company with important similarities for comparisons (discussed in paragraph 4.20);
- whether the merger leads to the loss of a company with important differences for comparisons (discussed in paragraph 4.21); and
- whether Ofwat could amend its approach to reduce the impact of the loss of a comparator (discussed in paragraph 4.22).

4.16 **Extent to which merger involves overlaps.** As a general principle, the greater the degree of overlap in the scope of merging parties' activities, the more likely a merger is to prejudice Ofwat's ability to make comparisons.

4.17 **Loss of an independent comparator.** A water merger brings under common ownership or control two or more water enterprises. In general, it is anticipated that companies under common ownership may behave in similar ways, and therefore a water merger may reduce the value of comparisons made by Ofwat. However, if a merger involves a water enterprise that Ofwat does not use to make comparisons, for example a small water company, Ofwat might not in practice lose an independent comparator.

4.18 **Extent to which the merger will change benchmarks.** If at least one of the merging companies is high performing in some areas, there is a greater risk of detriment for customers than if both companies are poor performers. This is because there is a risk that a high performing comparator might be lost as a result of the merger, which would have an adverse impact on cross-industry benchmarks, reducing the scale of challenge for other companies in the sector. At the same time there may be potential benefits of a high performing company taking over a poorer performing company, since it might improve the performance of a poorer performing company by providing improved efficiency or service to a greater number of customers, though this would need to be evidenced. When assessing whether one or both merger parties is high performing the CMA will examine their performance at the last price determination and their expected ranking at the next determination.

4.19 **Number and quality of independent observations that remain.** Any reduction to the number of comparators can have an impact on the robustness of Ofwat's analysis by reducing the number of independent observations. Ofwat currently has a higher number of water comparators 18 than sewerage comparators 10, so the loss of a water comparator is likely to have less impact than the loss of a sewerage comparator. The CMA will consider the impact of a merger on the number and quality of comparators, and whether this is likely to make Ofwat's analysis less robust, for example by reducing the precision of its cost modelling. Other things equal, the impact

from the loss of a comparator may be expected to increase for each successive merger that occurs, as fewer comparators would remain.

4.20 **Loss of a company with important similarities.** A merger can lead to the loss of a company with important similarities to the remaining companies. For example a merger between contiguous companies could affect Ofwat's ability to make comparisons across companies that are operating in similar circumstances facing similar issues.

4.21 **Loss of a company with important differences.** A merger can lead to the loss of a company with important differences from the remaining companies. These differences can take the form of best practice in some areas, or the use of innovative approaches. The loss of these important differences in approach as a result of the merger can have an adverse impact on Ofwat's use of comparators.

4.22 **A change to Ofwat's approach.** It may be possible for Ofwat to change the way that it regulates to offset, at least to some extent, the potential detriment from the loss of a comparator. This could include using different econometric techniques or a different choice of benchmark within the sample.

4.23 In considering the impact of a merger on Ofwat's ability to make comparisons the CMA will take into account all the factors set out above. Hence the impact depends on the circumstances of the merger under consideration and it is not possible to state, for example, a minimum number of comparators below which Ofwat's ability to make comparisons would be prejudiced.

4.24 Where possible and appropriate, the CMA will seek to quantify the adverse effect of the merger. For example, the CMA may seek to estimate the net present value of cumulative customer detriment if there is expected to be a lowering of the efficiency benchmark as a result of the merger. The CMA's decisions will be based on an assessment of both quantified and non-quantified impacts.

4.25 In reaching its decision at phase 1 the CMA will place significant weight on Ofwat's opinion on whether the merger is likely to prejudice its ability, in carrying out its functions, to make comparisons between water enterprises. The prospect of a clearance at phase 1, on the basis of a lack of prejudice, or acceptance of UILs is likely to be higher when the views of the parties and Ofwat on the impact of the merger are relatively aligned. In particular, where Ofwat considers that a merger is likely to lead to prejudice, but the parties disagree with its analysis, and a detailed analysis is required for the CMA to

take a decision, the CMA would typically expect the case to progress to phase 2.[54]

4.26 To ensure that there is no need to refer the case for a phase 2 investigation, the CMA needs to be able to make a decision that the merger is not likely to prejudice Ofwat's ability to make comparisons within the phase 1 timetable. Therefore, even where there is agreement in principle between Ofwat and the parties on whether the merger is not likely to lead to prejudice, the CMA may conclude that the issues are sufficiently complex that a referral is necessary to come to a conclusion. This would need to be considered on a case-by-case basis, based on a review of the specific circumstances of the evidence provided.

[54] The time and resource constraints of the phase 1 merger process imply that the CMA will not be able to undertake extensive analysis at phase 1 in order to arbitrate between widely differing estimates of a merger's impact provided by the parties and Ofwat.

5. Relevant customer benefits

Introduction

5.1 At phase 1, one of the exceptions to the CMA's duty to refer water mergers for an in-depth phase 2 investigation applies if the RCBs in relation to the water merger outweigh any prejudice to Ofwat's ability to make comparisons. Further, the CMA may also have regard to RCBs in deciding on any remedies in a phase 2 investigation.

5.2 This chapter provides further information on potential RCBs and their role in water merger investigations.

Relevant customer benefits

5.3 RCBs may be taken into account during both phase 1 and phase 2 of the special water merger regime. RCBs are limited to benefits to 'relevant' customers in the form of:

- lower prices, higher quality or greater choice of goods or services in any market in the UK; or
- greater innovation in relation to such goods and services.[55]

5.4 Relevant customers are customers of the merging enterprises at any point in the chain of production and distribution and are therefore not limited to final consumers, and include future customers.

5.5 In addition to falling within the description of RCBs, the CMA must believe that the benefit has accrued as a result of the merger, or is expected to accrue within a reasonable time period as a result of the merger, and that the benefit was, or is, unlikely to accrue otherwise.

5.6 The CMA will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit.

5.7 The paragraphs below provide examples of possible RCBs followed by an explanation of how they will be taken into account when considering whether a merger should be referred.

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[55] Paragraph 7 of Schedule 4ZA to WIA (which applies in phase 1 pursuant to section 33A(5) of WIA), and section 30 of EA02 as modified by regulation 6 of the Water Mergers Regulations.

Possible relevant customer benefits in water mergers

5.8 Mergers that lead to cost savings may generate RCBs if they lead to lower prices. A water merger might lead to cost savings due to economies of scale or scope in the supply of water and/or sewerage services. There may also be costs savings arising from improved water resource management, particularly if contiguous companies are involved.

5.9 The CMA will assess both the expected cost savings and the extent to which any such cost savings can be expected to lead to RCBs by being passed on to the merged company's customers. In assessing RCBs the CMA will have regard to the timing and relative certainty of the proposed benefits, including the mechanism by which cost reductions would result in lower prices.[56]

5.10 An RCB may also arise from higher quality. Possible examples of higher quality may arise from improved security of supply due to improved coordination between companies in sharing water resources, or improved service standards due to sharing of best practices. Before deciding that such a benefit is an RCB, the CMA would have to be satisfied that it would be unlikely to accrue without the merger, for example that it could not be achieved through investment by one or both of the parties on an individual basis.

5.11 In addition, an RCB could take the form of greater choice of goods or services, or greater innovation. Possible such other customer benefits that might be put forward by parties could include:

- Greater choice of tariffs or services. Although choice for customers in the water sector is limited, a merger could lead to greater availability of special tariffs. Other elements of choice of goods and services may become relevant once non-household retail competition is introduced.

- Positive impact on the level of innovation. A merger could in principle impact on the level of innovation, for example through greater effectiveness of research and development or the creation of innovative new company structures.

5.12 As above, the CMA would have to be persuaded on the basis of compelling evidence that such benefits were merger-specific, realistic, and would be

[56] In its South East Water/Mid Kent Water report (in 2007) the CC thought it likely that the acquirer would achieve savings in operating expenditure of at least £3.1 million a year, as well as further savings in capital expenditure. The CC expected customers to receive these benefits in the foreseeable future, but was not persuaded that, in the absence of an imposed remedy, they would be fully reflected in the price determination at PR09 (in 2009). See CC (2007), South East Water Limited and Mid Kent Water Limited report, paragraph 35.

passed through to customers. The CMA's approach to assessing RCBs is set out in detail in its general merger guidance.[57]

CMA approach to relevant customer benefits in phase 1

5.13 Where the CMA concludes that a merger may prejudice Ofwat's ability to make comparisons, it will further consider whether the likely prejudice is outweighed by RCBs in reaching its decision on whether the reference test is met. Quantitative and qualitative measures of both the prejudice and the RCBs may be considered. It is not sufficient that there are merely some theoretical benefits to customers: the merging parties must demonstrate that benefits will be passed on to customers and that those benefits will outweigh the identified prejudice.

5.14 In reaching its decision on whether a merger should be referred to phase 2 the CMA will place significant weight on Ofwat's opinion on whether the prejudice identified is outweighed by any RCBs relating to the merger.

5.15 At phase 1 the CMA may have regard to the effect of (or action on) any UIL in relation to any RCBs.[58] In practice, this means that where the CMA may have a choice of two UILs that are equally effective in terms of remedying the prejudice on Ofwat's ability to make comparisons, the CMA will prefer a remedy that preserves the RCBs. Where a benefit may have occurred absent the merger but would have taken longer than a reasonable period, the CMA may take into account the time gained as an RCB. For further information on UILs see Mergers: Exceptions to the duty to refer and undertakings in lieu of a reference guidance (OFT1122)*,* Chapter 3, paragraph 3.23 and Chapter 6, paragraph 6.9 to 6.16

CMA approach to relevant customer benefits in phase 2

5.16 At phase 2, in deciding on remedies the CMA may have regard to the effect of any such action on any RCBs in relation to the merger, provided that: (a) a consideration of those benefits would not prevent a solution to the prejudice concerned; or (b) the benefits that may be expected to accrue are substantially more important than the prejudice concerned.[59] If the first circumstance is applicable, the CMA will, wherever possible, seek to choose remedial action that would not adversely affect the RCBs.[60] If the second

[57] OFT1122.
[58] 33D (5) of the WIA.
[59] Sections 35(7) and 36(6) of EA02 as modified by regulation 11 of the Water Mergers Regulations.
[60] This was the approach followed by the CC in the South East Water/Mid Kent Water inquiry, in choosing a price reduction remedy in preference to a full divestiture remedy. The CC explained in its final report in paragraph 37: 'We noted that full divestiture would result in the loss of all relevant customer benefits arising from the merger.

circumstance is applicable it may be taken into account in the CMA's decision on whether remedial action should be taken, and if so, what action that should be.

We thought that a price reduction remedy would effectively mitigate the adverse effects we expect to result from the limited prejudice that we have identified, and would at the same time allow relevant customer benefits to be realised.'

6. Approach to remedies

Introduction

6.1 The general aim of remedies in water mergers is to remedy, mitigate or prevent the prejudicial effect of the merger on Ofwat's ability to make comparisons.

6.2 The changes introduced to the special water merger regime by the WA14 create the possibility of voluntary remedies at the phase 1 stage if the merger parties offer UILs, which may be of a comparable form to remedies that the CMA would be expected to implement in phase 2.

6.3 The principles for remedies at both phase 1 and phase 2 in water mergers as well as guidance on what may constitute an effective remedy is discussed below. Further general merger guidance on remedies is given in the CMA's exceptions to the duty to refer guidance[61] and the merger remedies guidance.[62] In addition, general process guidance is set out in Chapter 8 of CMA2.

6.4 The procedure for the CMA's engagement with Ofwat during the remedy process (at phase 1) is in Chapter 2.

Range of potential remedies

6.5 Remedies may be either structural or behavioural.

6.6 Structural remedies are intended to restore all or part of the industry structure prior to the merger, for example:

- Partial prohibition or divestiture (covering part of one or more of the merging companies' businesses, for example either through a reduced equity stake; or through the sale of a non-contiguous part of the water company, which could create an additional independent comparator).

- Prohibition of a proposed merger.

- Divestiture of a completed acquisition.

6.7 For divestitures at either phase 1 or phase 2 the CMA will approve the purchaser before the divestiture is allowed to be completed. Further guidance

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[61] OFT1122.
[62] *Merger Remedies: Competition Commission Guidelines November 2008* (CC8).

on purchaser approval is in Chapter 8 of CMA2, in particular paragraphs 8.32 to 8.49.

6.8 Behavioural remedies are intended to reduce the prejudice to Ofwat's ability to make comparisons and any adverse effect resulting from the prejudice. An example might be an amendment to the company's licence which could include:

- a requirement to maintain separate management and/or separate accounting and reporting arrangements that are subject to external assurance assessments (this could, for example, involve the creation of a separate company to manage particular parts of the supply chain such as retail, water resources or networks); and
- changes to prices and/or service quality commitments for customers of one or both companies. In such circumstances the time period that such commitments would apply must be clearly identified.

Phase 1 – Undertakings in lieu of a reference

6.9 Where the CMA decides in phase 1 that the reference test is met, the parties may offer UILs.[63] The CMA will consider whether the proposed UILs would remedy, mitigate or prevent the prejudicial effect of the merger on Ofwat's ability to make comparisons. When considering UILs the CMA must have regard to the need to achieve as comprehensive a solution as reasonable and practicable to the prejudicial effect on Ofwat's ability to make comparisons. The CMA may have regard to the effect of accepting UILs on any RCBs in relation to the merger. Where UILs are offered by the merger parties the CMA must consider Ofwat's opinion on the effectiveness of the UILs offered.[64] Guidance on the CMA's general policies on UILs is available in OFT1122 and Chapter 8 of CMA2.

6.10 In order to accept UILs the CMA must be confident that the potential concerns regarding prejudicial effect that have been identified in its investigation would be resolved by means of the UILs without the need for further investigation. UILs are therefore appropriate only where the remedies proposed to address any concerns are both clear cut and capable of ready implementation.[65]

[63] Section 33D of WIA.
[64] See Chapter 3, paragraph 2.4 for further information.
[65] For further detail see OFT1122, paragraphs 5.6 & 5.7.

6.11 The CMA will generally expect UILs to restore Ofwat's ability to make comparisons between water enterprises to a level similar to that which existed pre-merger.

6.12 Structural remedies are capable of being clear-cut solutions in water mergers as they are in the wider economy and in line with its general merger guidance the CMA will consider behavioural remedies for mergers in markets in which there already exists a significant degree of regulation (such as water mergers).[66]

6.13 This reflects the need to identify UILs that can be implemented. Structural undertakings can satisfy these conditions and can be implemented in all markets. Within regulated sectors, an agreement to clear cut and enforceable licence modifications may be similarly effective. However, there would need to be a binding commitment to any such licence modifications, and the form would need to be clear and unambiguous.

6.14 Whilst this provides flexibility to consider both behavioural and structural remedies on a case-by-case basis, the CMA will nevertheless expect UILs to remedy, mitigate or prevent the prejudicial effects to meet the test that no reference to phase 2 is required. The CMA would not accept behavioural remedies that are solely for the purpose of providing RCBs (ie benefits to the customers of the merging companies) in phase 1, where there is evidence of likely prejudice arising from the merger, and the behavioural remedies do not address that prejudice. This is comparable to the general merger regime, where RBCs are a potential exception to the duty to refer a merger to phase 2 however any RCBs must outweigh the SLC and any adverse effects of the SLC in all affected markets at phase 1.[67] A phase 2 investigation allows the CMA to take a balanced view of the way in which any RCBs might form part of the remedial action required, the phase 1 process should not attempt to pre-empt this if at phase 1 it is identified that a prejudice is likely to be arising from the water merger.

6.15 The CMA would expect parties to engage with both the CMA and Ofwat at the earliest opportunity to discuss potential UILs.

[66] For further detail see OFT1122, paragraph 5.43.
[67] Paragraph 5.13 of OFT1122 states that: 'the [CMA] will not accept undertakings in lieu that do not address the identified competition effects but which are designed instead to 'lock in' sufficient customer benefits to outweigh the risks of a substantial lessening of competition arising'.

Phase 2 – Remedial action

The remedy questions

6.16 If the CMA has decided on a reference under section 32 of the WIA that the water merger results in a prejudicial outcome to Ofwat's ability to make comparisons, the CMA has to decide whether to take action to remedy, mitigate or prevent the prejudice, or any adverse effect that might result, and to decide what action to take. In deciding what action to take, the CMA may have regard to the effect of any action on RCBs.

6.17 The CMA should first consider whether the CMA itself should take remedial action to remedy the prejudice to Ofwat or any adverse effect which has resulted from, or may be expected to result from, the prejudice to Ofwat's ability to make comparisons. This would take the form of either using its order-making powers or accepting undertakings from the parties (see paragraphs 6.19 and 6.20 below). The second question is whether the CMA should recommend that remedial action should be taken by others, such as ministers and regulators, including Ofwat. Such recommendations cannot bind the person to whom they are addressed. They can be additional or alternative to any remedial action taken by the CMA. The third question specifically asks the CMA to address what action should be taken and what it is designed to address.

6.18 In deciding these questions, the CMA shall 'in particular have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the prejudice to Ofwat and any adverse effects resulting from it'.[68]

6.19 In general, the CMA's decision as to which form of remedy to use will be determined by issues of practicality. When the particular circumstances of the case point to the need for action to be taken speedily, the CMA may choose to implement the remedy by way of an order to avoid delay while undertakings are negotiated.

6.20 The CMA welcomes the possibility of accepting undertakings that the parties put forward as being those they are willing to enter into and which the CMA considers would provide a comprehensive solution. However, even if the parties do propose undertakings, the CMA may consider alternative remedies.

[68] Sections 35(6) and 36(5) of the EA02.

Consideration of appropriate remedies

6.21 Although the CMA must always consider the appropriateness of any remedial action, it is likely that it would decide to take remedial action if it has decided that a merger results or is expected to result in a prejudicial outcome. Examples of exceptional circumstances where the CMA might conclude that no action was appropriate might be where the costs of any practicable remedy seemed disproportionate in the light of the extent of the prejudice to Ofwat. However, even in these circumstances, the CMA, having decided that no action should be taken by it, might recommend action to be taken by others.

6.22 The WIA enables the CMA, under certain circumstances, to take into account, any RCBs that arise from the merger, when deciding upon remedial action. Those circumstances are: first, when the consideration of those benefits would not prevent a solution to the prejudice concerned; and second, when the benefits that may be expected to accrue are substantially more important than the prejudice concerned.[69] This consideration too might lead to the decision that no action should be taken. The circumstances in which RCBs can be considered, and what constitutes an RCB, are described above in Chapter 5.

6.23 The remedial action that the CMA will decide should be taken will always depend on the facts and circumstances of the case. The CMA will consider remedy options proposed by the merger parties and others in addition to its own options. When deciding what an appropriate remedy is, it will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality. These are discussed in the next sections.

The cost of remedies and proportionality

6.24 The CMA must have regard to the reasonableness of any remedy, and this will include consideration of the costs of any action it might decide is appropriate. It will not require a remedy that it considers is disproportionate in relation to the prejudice to Ofwat’s ability to make comparisons or any adverse effects resulting or expected to result from such prejudice. If it is choosing between two remedies that it considers would be equally effective, it will choose the remedy that imposes the least cost to the parties or that is least restrictive.

[69] Sections 35(7) and 36(6) as modified by regulation 11.

6.25 The CMA will generally include in its consideration of parties' costs the costs of implementing a remedy. However, for completed mergers it will not normally consider the costs of divestiture to the parties as it is open to the parties to make merger proposals conditional on competition authorities' approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be prohibited subsequently, and the CMA will normally expect this risk to have been reflected already in the acquisition price.

6.26 The CMA will endeavour to minimise any ongoing compliance costs to the parties, subject to the effectiveness of the remedy not being reduced, and will have regard to the costs to the CMA and/or Ofwat in implementing, and monitoring compliance with, any remedies that the CMA may put in place or recommend.

Effectiveness of remedies

6.27 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.

6.28 First, a factor bearing on the effectiveness of any remedy is whether the remedy is clear to the person to whom it is directed and also to other relevant interested parties, for example the CMA, which has responsibility for monitoring compliance, and Ofwat. Other examples of interested parties include consumer groups (notably the Consumer Council for Water), other regulators including the Environment Agency and the Drinking Water Inspectorate, competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the CMA's attention any concern that a remedy is not being complied with.

6.29 A second consideration is the prospect of the remedial action being implemented and complied with. Some remedies are a commitment as to future behaviour or to a standard of acceptable future behaviour. There may be less certainty with some remedies compared with others that the remedies will have the desired effect. A relevant factor will be the ease of monitoring notwithstanding the possibility of establishing a compliance programme. The effectiveness of any remedy is reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One-off remedies that change the structure of the market (so-called structural remedies) are (subject to the proportionality test as described in paragraph 6.26) likely to be preferable to remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) as they address the effect of the merger directly and, once implemented, will require comparatively little, if any, monitoring or enforcement of compliance.

6.30 A third consideration is the timescale within which the effects of any remedial action will occur. Some remedies will have a more or less immediate effect, for example in eradicating any prejudice to Ofwat's ability to make comparisons, while the effects of others will be delayed. There may be particular uncertainty about the timescale within which results can be expected when the remedy calls for action by some other person, for example a recommendation to government to change regulations. The CMA will tend to favour a remedy that can be expected to show results in a relatively short time period – provided it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.

Types of remedies

6.31 A summary of the potential types of remedies that the CMA will consider is set out in paragraphs 6.5 to 6.8 above.

Addressing the prejudice to Ofwat's ability to make comparisons

6.32 In addressing the question of whether a particular remedy would be appropriate, and would provide as comprehensive a solution as is reasonable and practicable to address the prejudice to Ofwat's ability to make comparisons and any adverse effects resulting from the prejudice, the CMA will take account of how adequately the action would remedy, prevent or mitigate the concerns caused by the merger.

6.33 The CMA's starting point will be to choose remedial action that will prevent the prejudice to Ofwat's ability to make comparisons and any resulting adverse effects. Given that the effect of the merger is to change the structure of the industry, remedies that aim to restore all or part of the status quo ante industry structure are likely to be a direct way of addressing the adverse effects. However, issues such as the effectiveness of the remedy, the costs associated with the remedy and RCBs that would be forgone may mean that other types of remedy need to be considered. The CMA may decide to impose more than one type of remedy.

Prohibition and divestiture

6.34 With a proposed merger, the most effective remedy will often be the prohibition of the merger. A complication may be that the potential acquirer has invested in a partial shareholding in the target company that it is seeking to increase through a proposed further transaction. This may need to be reduced to a specified maximum level, below which the CMA judges there could be no possibility of material influence, within a specified and reasonable time period.

6.35 For mergers that have already completed, the most effective remedy may be divestiture of the acquired business. The CMA would expect remedial action, including divestiture, to occur within a specified and reasonable time after the CMA has published its decision. The length of the period will depend on the circumstances but will normally be a maximum of six months. Until the divestiture is complete, measures intended to safeguard the competitiveness of the business, including the appointment of a trustee or other person to monitor the process, may be implemented. The CMA will generally insist on having the right to approve the prospective purchaser and the divestiture agreement before the parties may proceed with the divestiture.

6.36 As an alternative to either prohibition or divestiture of the acquired business, the CMA may consider divestiture of the acquirer's holdings in other water enterprises, where this would appropriately restore Ofwat's ability to make robust comparisons.

Partial prohibition and divestiture

6.37 Partial prohibition and divestiture (rather than outright prohibition or full divestiture) may be an appropriate remedy in some cases. This would be the case when Ofwat's ability to make comparisons would be restored by divestiture of part of one of the merging companies. A partial divestiture might be of a stand-alone, going-concern business or of physical assets, for instance those serving part of a company's licence area or the retail operation (separated from its wholesale operation). The *Merger Remedies: Competition Commission Guidelines (CC8)* outlines the CMA's general approach to defining divestiture packages (see Part 3: Divesture and intellectual property).

6.38 There are two key questions that will help to determine whether partial divestiture can be an effective remedy in a water merger case:

- whether the business or assets to be divested provide the basis of a viable business that can operate independently of the merging firms and, in a reasonably short time, say within one year, can be expected to provide an effective comparator to Ofwat; and
- whether there is a suitable purchaser of the assets who will be capable of operating the assets and running a viable, independent and competitive business.

6.39 As with other remedies, the CMA will have regard to RCBs in considering partial prohibition and divestiture.

Behavioural remedies

6.40 The CMA will also consider whether to recommend that action be taken by others, in particular Ofwat. This could include changes to the merging companies' price caps; performance commitments and incentives; business separation; and licence conditions requiring the provision of information to Ofwat. Paragraph 6.8 of this guidance reviews a range of potential behavioural remedies.

Annex A: Principal stages and interaction between the CMA and Ofwat during a phase 1 investigation

Day[70]	Stage	CMA	Ofwat
Typically at least two weeks before notification	Pre-notification	The CMA and Ofwat discuss the transaction with the parties, including the relevant information required from the parties necessary to start the investigation.	
1	Commencement of phase 1	The CMA publishes on its webpages the notice of commencement of the initial period of investigation	
1	Information gathering	The CMA and Ofwat will continue to liaise with the parties throughout the 40 working day period and request further information as appropriate.	
1-10	Invitation to comment	The CMA will publish an invitation to comment notice on its webpages inviting views from third parties. The CMA will provide Ofwat with any responses received by third parties that are relevant for its assessment.	
15–20	State of play meeting	The CMA will hold a 'state of play' discussion with the merger parties	Ofwat will attend the state of play meeting. Ofwat will provide the CMA with a draft opinion on the transaction no later than day 15.
Phase 1 decision (for cases raising no serious concerns)			
By day 40	Phase 1 decision (for cases raising no serious concerns)	CMA clears the transaction and issues a clearance decision.	
Phase 1 decision process (for cases raising more complex or serious concerns)			
By day 40 but typically no earlier than day 25	Issues letter	CMA will share and discuss the issues letter with Ofwat before sending it to the merger parties. CMA sends an issues letter to the parties. CMA organises an issues meeting	Ofwat provides the CMA with its final opinion on the issues raised by the merger no later than two working days before the issues letter is sent to the parties. Ofwat provides the CMA with a confidential and non-confidential version of its opinion; the parties will receive the non-confidential version when they receive the issues letter.
	Issues meeting	The CMA will consider any response Ofwat subsequently makes to the parties response to the issues letter. The CMA may ask Ofwat to provide supplementary information in relation to its opinion or additional evidence submitted by the parties.	Ofwat will attend the issues meeting. Ofwat will be available to meet the CMA case team and explain the reasoning and analysis in its advice. Where appropriate Ofwat will provide the CMA with its reply to the parties' response to the issues letter and issues meeting.

[70] Working days.

Day[70]	Stage	CMA	Ofwat
By day 40	Phase 1 decision (for cases raising more complex or serious concerns)	CMA holds an internal case review meeting.	
	Publication of the decision	CMA publishes notice of its decision (whether the test for reference has been met).	
After day 40		At a later date the CMA will publish a full non-confidential decision.	Ofwat will issue a non-confidential version of its advice to the CMA following the publication of the CMA's full decision.
Undertakings in lieu of a reference			
Before day 40	Preliminary discussion on UILs	The CMA will inform Ofwat as soon as practical of any material discussions on UILs. The CMA will share with Ofwat any relevant information provided by the parties on potential UILs.	(Where appropriate) Ofwat may attend meetings and/or calls between the CMA and the merging parties when discussing UILs. Ofwat will provide the CMA with a written or oral provisional review[71] on any potential UILs that have been raised by the parties.
0–5 days after reference decision	Parties offer UILs	If no UILs are offered within 5 days of the decision the CMA will refer the merger for a phase 2 inquiry. CMA will share with Ofwat UILs offered.	
0–10 days after reference decision	Consideration of the UILs	The CMA considers the UILs and makes a decision whether to provisionally accept or reject the UILs offered.[72]	Ofwat provides the CMA with a provisional view on the UILs offered by the parties no later than 9 days after the reference decision.
Within 50 days of the reference decision	Agreement and acceptance	The CMA gives detailed consideration to the UILs offered and publishes draft UILs for comment. If UILs are agreed the CMA publishes notice of acceptance; if not the transaction is referred to phase 2.	Ofwat submits its final views to the CMA on the UILs offered by the parties no later than two days before the consultation period begins.[73]

[71] This provisional review may not reflect Ofwat's final formal view and may not have approval from its board.
[72] Where there is a disagreement between the CMA and Ofwat on the UILs offered, the CMA will inform Ofwat before it takes its final decision. Where UILs proposed by the merger parties are rejected by the CMA the merger will proceed for a phase 2 investigation.
[73] For further information please see the statement of intent.

Annex B: Principal stages of a CMA merger investigation

1. Figure 1 below provides a high-level summary of the principal stages in phase 1 and phase 2 merger investigations undertaken by the CMA under the EA02 from initial contact with the CMA, through to a full phase 2 investigation.

Figure 1: CMA merger investigations – principal stages