CONSULTATION ON CMA'S DRAFT GUIDANCE ON WATER AND SEWERAGE MERGERS PROCEDURE AND ASSESSMENT
SOUTH EAST WATER'S RESPONSE

OCTOBER 2015

This paper sets out South East Water's (SEW) views in response to the Competition and Markets Authority (CMA) draft guidance on water and sewerage mergers procedure and assessment.[1]

1 INTRODUCTION

South East Water (SEW) in its current form is the result of the merger of five former water companies in the south east of England. Under the ownership of SAUR four smaller companies were merged soon after privatisation in the 1990s. SEW in an earlier form was involved in the unsuccessful SAUR/Mid Kent/General Utilities merger referral in 1997. Most recently however it went through the post Enterprise Act merger regime with the Competition Commission (CC, one of the predecessors to the CMA) in the 2006 merger of the former South East Water (fSEW) and former Mid Kent Water (fMKW).[2] We draw on these experiences in particular the MKW/SEW merger to inform the response below.

SEW is supportive of a transparent merger regime and is aware from first-hand experience of the long term benefits of mergers to customers – particularly in the areas of water resources planning and security of supplies.

The comments we have on the consultation are presented under the following headings:

- Comments on overall objectives,
- Comments on improving stakeholder certainty, and
- Comments on the consultation questions.

2 OVERALL COMMENTS ON OBJECTIVES AND APPROACH

Overall objective

The Cave Review 2009[3] examined the special merger regime on the basis that the current regime discouraged merger activity and that potentially there might be benefits associated with a relaxation of the regime:

[1] CMA water and sewerage mergers guidance
[2] CC South East Mid-Kent Water merger report
[3] Professor Martin Cave led an independent review of competition and innovation in water markets between March 2008 and April 2009. The Review published its final report on 22 April 2009. http://www.defra.gov.uk/publications/2011/12/06/cave-review/

'The special merger regime represents a significant barrier to further consolidation, adversely affecting the scope for efficiency gains, financing costs and resource optimisation. I propose that the regime is reformed and restricted to those mergers which are likely to have a significant impact on Ofwat's ability to undertake comparative competition. <u>Stakeholders should also be given greater certainty about the process</u>.'

The need for stakeholders to be given greater certainty about the process was made clear in the Cave Review, and our overall comments are very much focussed on this aspect.

Overall the consultation seems to be focused on making the merger process smoother once a purchase decision has been made by the relevant parties. We believe that the current proposals achieve the objective of clarity of process, however, we believe more work could be done to bring more certainty and predictability to the outcome of the process. Clearer foresight and predictability of the assessment outcome at the pre-purchase stage could well encourage a greater number of customer-favourable mergers to take place.

We consider the two main barriers in this respect to be:

- The inability of the parties to predict the likely outcome of a referral pre-purchase;
- The cost of an unsuccessful referral especially if divestment is required which will likely occur under suboptimal sale conditions.

The proposals outlined in the consultation do not address these two issues as the document concentrates on a post-purchase process. The objective therefore of increasing the likelihood of customer-favourable mergers is unlikely to be realised - instead what has been achieved is the potential for a shorter process. We would suggest that the length and complexity of the process is not a key barrier when compared to the two barriers mentioned above.

Providing clarity and certainty

A key objective of any change to the merger regime should ensure that purchasers can, using Ofwat published information, accurately predict a likely outcome of the process so that they can proceed with the purchase with a better understanding of cost and risk. It is not clear to us that the current proposals deliver this.

We believe the level of uncertainty that remains prior to purchase under the proposed approach remains broadly similar to the current regime and if customer-favourable mergers are to be encouraged more certainty of outcome needs to be provided.

The Pennon/Bournemouth water merger referral

The provisional findings from the Pennon/Bournemouth merger referral[4] provided a useful guide to the current assessment protocols at the CMA. However the CMA makes it clear that this merger has been assessed under the current regime:

'We note that this inquiry has arisen at a time when changes to the special water merger regime are being implemented. Those changes are not yet in force. This inquiry falls under the existing regime and we have carried out our assessment under the current CMA guidance.'[5]

As a result water companies can only really gain an insight into how the CMA would approach and assess a phase 2 investigation in the new regime. In the new regime it appears that companies will need to present evidence in a way very similar to how they would do currently – but this time to Ofwat in the first instance, in an attempt to get phase 1 only approval. The level of scrutiny proposed by Ofwat in section A1.5 'company evidence' in their recent consultation document[6] feels at odds with a simplified process. Ofwat seem to suggest they will evaluate the quality of the evidence, however there is no reference for assessing what the evidence shows. In our view there remains considerable uncertainty around the strength of the role and weighting of the views of Ofwat in a phase 1 assessment.

For increased certainty merger parties will want to know the likely costs of submitting an application and balance this with the likely outcome with the CMA. It is our view that the perceived risk to the purchaser of the phase 1 process needs to be considerably reduced or the purchaser will have to assume that the full costs of both the phase 1 and phase 2 processes will be incurred. We don't believe that this is the intended outcome of the overall process. It is difficult to judge from the recent Ofwat consultation and the current CMA consultation just how high the bar is for a successful outcome in phase 1 and then possibly again in phase 2.

In its preliminary findings for the recent Pennon/Bournemouth merger the CMA set out that *'ultimately the question of whether there is prejudice to Ofwat's ability to make comparisons is a matter of judgement based on the evidence as a whole.'*[7]

We believe greater certainty can be achieved by developing and issuing an approved methodology for assessment of detriment and benefit that can be reasonably worked through and provide purchasers with a better view of the likelihood of a referral to phase 2.

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[4] Completed acquisition by Pennon Group plc of Bournemouth Water Investments Limited Preliminary findings

[5] p41, para 6.14.

[6] Consultation on Ofwat's approach to future mergers and statement of method , 28 May 2015.

[7] p40, para 6.12

3 CONSULTATION QUESTIONS

Q1. Is the content, format and presentation of the draft guidance sufficiently clear? If there are particular parts of the guidance where you feel greater clarity is necessary, please be specific about the sections concerned and the changes that you feel would improve them.

As discussed in our general comments section above we believe that the objective of clarity of process has been achieved in the draft guidance but not necessarily the objective of increased certainty.

Q2. Is the level of detail helpful? Are there any parts of the draft guidance which you feel would be improved by being either more, or less, detailed?

The level of detail is clear and helpful.

Q3. Is the draft guidance sufficiently comprehensive? Does it have any significant omissions? Do you have any suggestions for additional content that you would find helpful?

As discussed in our general comments section we believe greater certainty of the process can be achieved by developing and issuing an approved methodology for assessment of detriment and benefit that can be reasonably worked through and provide purchasers with a better view of the likelihood of a referral to Phase 2.

For example – in the Pennon/Bournemouth case the CMA provisional findings were:

'Overall, we provisionally find that the adverse impacts that we have identified in our inquiry <u>are not significant enough</u>, either individually or in combination, to amount to prejudice to Ofwat's ability to make comparisons between water enterprises under the Enterprise Act 2002 (the Act).

It would give greater clarity and certainty if the level of significance that would cause prejudice could be more clearly identified – particularly as the new merger regime now proposes two different evidential thresholds. Section 4 of the consultation document sets out the two different legal tests and gives the different evidential thresholds on prejudice that apply at phase 1 compared to phase 2:

'The question for the CMA at phase 1 is whether the merger is <u>not likely</u> to prejudice Ofwat's ability to make comparisons between water enterprises. At phase 2 the question for the CMA is whether the merger <u>has or may be expected to</u> prejudice Ofwat's ability to make comparisons.'[8]

It would be of considerable help to potential merger parties to be given guidance on the appropriate level of significance for CMA approval at each phase – or at least for phase 1.

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[8] p22, para 4.2.

Q4 Do you have any other comments about the draft guidance?

We have made these comments in the general comments section above.