Department for Environment, Food and Rural Affairs

May 2012

Call for Evidence – Reform of the Water Special Merger Regime

Contents

Topic of this Call for Evidence

This call for evidence seeks views on proposed reform of the water special merger regime for the water industry in England and Wales.

Scope of the Call for Evidence

The purpose of this call for evidence is to seek views and evidence which will assist in the preparation of an impact assessment on proposed changes to the Special Merger Regime in the water sector. In particular, we are seeking views and evidence on proposals to increase the threshold at which mergers are automatically referred by the Office of Fair Trading (OFT) to the Competition Commission (CC) from the current level of £10 million.

Geographical scope

The special merger regime applies to mergers between water companies in England and Wales.

Impact Assessment

An impact assessment has not been prepared to accompany this call for evidence. The evidence collected will be incorporated into an impact assessment that will accompany any legislative proposals to change the £10 million threshold.

Code of Practice on Consultations

This Call for Evidence is in line with the Code of Practice on consultations. This can be found at www.bis.gov.uk/policies/bre/consultation-guidance

How to respond

Comments should be sent by 28th June either by letter or e-mail to:

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In your response, please:

- Include your name and address;
- Explain who you are and, where relevant, whom you represent;
- Order your comments under the relevant question; and

- Include a summary of your comments if they are more than three pages long.

In line with Defra's policy of openness copies of responses that we receive will be made publicly available, at the end of this 'call for evidence', through the Defra Information Resource Centre, Ergon House Lower Ground Floor, Horseferry Road, London, SW1P 2AL. If you do not consent to this, you must clearly request that your response be treated confidentially. Any confidentiality disclaimers generated by your IT system in e-mail responses **will not** be treated as such a request. You should also be aware that there may be circumstances in which Defra will be required to comply with its obligations under the Freedom of Information Act and the Environmental Information Regulations.

Background

The Water White Paper – *Water for Life*[1] – sets out the Government's vision for future water management in which the water sector is resilient, in which water companies are more efficient and customer focussed, and in which water is valued as the precious and finite resource it is. It also set out plans for reform of the water sector, building on the strengths of the current industry structure and regulatory regime and reflecting Martin Cave's recommendations that change should be evolutionary and introduced step by step.

However, the White Paper, whilst recognising the current strengths of the water industry and what has been achieved since privatisation, recognised that there is potential for further consolidation of water companies that could result in efficiency savings and help address the current challenges facing the sector.

The White Paper therefore committed the Government to consult on whether a higher merger threshold to exclude more mergers from automatic referral to the Competition Commission was appropriate. A threshold of £70m was suggested, in line with the recommendations of the Cave Review and with the threshold applying in other sectors.

The Special Merger Regime

The water sector in England and Wales comprises 22 incumbent regional monopoly companies, including 10 large water and sewerage companies and 12 smaller water only companies. There are also a number of very small Newly Appointed entrant companies sometimes known as inset appointees. The 22 appointed incumbent companies and inset appointees are all subject to the special merger regime[2] that is designed to protect Ofwat's ability to make comparisons between companies for the purposes of comparative regulation.

This regime has been in place since the early 1990s and since 2004 has include a reference test under which the Office of Fair Trading (OFT) must refer to the Competition Commission (CC) any merger of two or more appointed companies where both company has an annual turnover that exceeds £10m.

Upon receiving a reference from the OFT, the CC is required to determine whether a water company merger has taken [can take?] place and whether it may be expected to prejudice the ability of Ofwat to make comparisons between different water companies for the purposes of

[1] http://www.defra.gov.uk/environment/quality/water/legislation/whitepaper/

[2] http://www.legislation.gov.uk/ukpga/1991/56/section/32. It is also worth noting that licensees under the Water Supply Licensing regime are not subject to the Special Merger Regime controls.

protecting consumers in the absence of real competition. If the CC determines that there is a prejudice to Ofwat's ability to make comparisons then it must decide whether, and what, action should be taken. The remedies that the CC can impose may be structural (for example divestment) or behavioural (for example amendments to the companies' licence, for instance regarding the provision of information).

The test applied by the CC is not an evaluation of the costs and benefits of the proposed merger. Instead the test examines any detriment as a result of the merger to Ofwat's ability to compare companies under its comparative regulation regime. Even where a proposed merger would be in the interests of the customers of the merging companies (i.e. due to the realisation of efficiencies), the very fact that the merger reduces the number of comparators available to Ofwat would give rise to a prejudicial effect to all customers against which the CC would need to consider whether to take any action.

The merger regime exists explicitly to protect the particular approach to regulation that is currently adopted by Ofwat, which, in simple terms, uses comparative information between different companies to both quantitatively and qualitatively identify the best performing company within the sector for in a range of areas and incentivises the other companies in the sector to improve to meet that level of performance. This could for example involve an efficiency challenge to provide a good service at a level of cost approaching that of the most efficient company in the sector, or alternatively to meet a level of customer satisfaction or service. Following a merger between two water companies the number of comparators available to Ofwat would obviously decrease by one and this could affect Ofwat's ability to use this kind of regulatory tool.

The £10 million turnover threshold captures all but the smallest water company (Cholderton and the inset appointees).

Cave Review of Competition and Innovation in Water

The Cave Review[3] examined the special merger regime on the basis that the low jurisdictional threshold for the CC to examine a merger discouraged merger activity between water/water and sewerage companies and that potentially there might be benefits associated with a relaxation of the regime. It suggested that greater capital market competition would encourage greater efficiencies and company driven improvements to services. The aim of greater capital market pressures would be to deliver water and sewerage services at lower costs to the environment and customers through increased pressure on management to improve their services, the more rapid transfer of best practice, greater economies of scale, and, in the case of mergers between neighbouring companies greater optimisation of resources.

The Cave review therefore recommended "*raising the threshold for the special merger regime to a maximum of £70m and reforming the threshold so that it applies to the smallest company, as in the wider regime. The UK Government should then keep this threshold under review*".

The scope of the special merger regime was also considered in the Independent Review of Charging for Household Water and Sewerage Services led by Anna Walker. During the consultation stage of the review questions were raised with the review team as to whether the special merger regime remained appropriate, and whether it was ossifying the sector unnecessarily.

[3] http://www.defra.gov.uk/publications/2011/12/06/cave-review/

The review acknowledged that consideration of the regime was beyond its scope, but it did conclude that the industry's structure looked complex and that mergers could potentially encourage a reduction in operating and overhead costs and possibly more transfers of water between areas. It recognised the importance of comparators but considered that it should be possible to preserve the important comparators with a more flexible regime.

The review team therefore recommended that the UK Government and Welsh Assembly Government review the merger regime in the water industry to ensure that it was sufficiently flexible to meet future challenges while still ensuring that the industry could provide appropriate comparators to enable Ofwat to regulate effectively.

Consultation responses

In September 2009 Defra and the Welsh Assembly Government undertook a public consultation on the final report of the Cave Review and its recommendations. The consultation sought views from stakeholders and the general public on competition in the water and sewerage sector as well as the specific recommendations of the Review. In total 53 responses were received on the public consultation.

The key questions and responses in relation the special merger regime are summarised below. Further detail can be found in the summary of responses to the consultation.[4]

Should the turnover threshold for water mergers be increased to £70m? What level would encourage water mergers where the benefits of consolidation to all customers and shareholders of the merging undertakers outweighed the costs to all customers from the impact of the regulatory regime? Should the special water merger regime incorporate the share of supply test?

In response to the above question 14 respondents supported increasing the threshold, seven disagreed and two suggested that further work was required. The remaining thirty either did not provide an answer to the question or did not express a particular view either way.

Amongst the appointed water companies who responded to this question, seven supported increasing the threshold to £70m and four objected. Generally, increasing the threshold was supported by companies with a turnover greater than £70m and rejected by small water companies with a turnover of less than £70m. Amongst new entrants in the Water Supply Licensing regime (who are not subject to the special merger regime) all four supported raising the threshold noting that the merger controls should be more aligned to the standard merger regime.

Ofwat did not support a rise in the threshold at that time. They noted that it would require a significant departure from their existing regulatory approach and that until an alternative approach had been identified which provided similar protection for consumers it would continue to need to use comparators..

The Consumer Council for Water (CCWater) were concerned that raising the threshold for mergers would lead to more mergers taking place without any certainty that the benefits from those mergers would be passed on to customers. The Environment Agency (EA) cautiously

4 http://webarchive.nationalarchives.gov.uk/20111030130858/http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/cave-review-consult-summary.pdf

supported raising the threshold believing that the existing approach had constrained the opportunities for co-ordination.

Three water companies suggested alternative threshold levels, and one large water and Sewerage Company suggested that £100m was a more appropriate threshold while a smaller water only company suggested that a threshold of £25-£30m was more appropriate as the higher threshold would put too many water only companies at risk of takeover.

Ofwat Commissioned Research into Alternatives to Comparative cost assessment

One of the ways in which Ofwat has historically made comparisons is in its approach to comparative cost assessment. Ofwat and other economic regulators use cost modelling as a way of determining the relative efficiency of companies and therefore setting efficient costs for monopolies in the absence of competition. A report commissioned by Ofwat from Cambridge Economic Policy Associates (CEPA)[5] looked at the use of panel[6] and sub-company data and examined the extent to which Ofwat could make use of these alternative approaches in assessing efficient costs, for the purposes, amongst others, of setting price limits.

The report found that the use of panel data could be beneficial for cost assessment as it would increase the number of observations and hence improve the statistical significance of cost models. This benefit could apply even without changes to the merger regime, though panel data could also facilitate this. The report also recognised that the range of data available may in some cases be limited where its collection has only recently been initiated, for example in the case of accounting separation which was implemented in 2010, which meant that Ofwat would need to use a panel approach with care at the next price review in 2014. However CEPA recommended that Ofwat should focus on backward looking data at the next price review but suggested that Ofwat should look at the feasibility of using forward-looking data based on forecasts within the business plans of companies..

The report also considered the use of sub-company and sub-activity data (e.g. data on water resources by zone or sewage treatment by plant), which could be expected to provide benefits to price setting in terms of better cost transparency and improved modelling. However, the report does note that results from this data could exhibit substantial biases, particularly sub-activity data. And that sub-activity data would be unduly onerous for the purposes of setting price limits with the exception of the small number of areas where Ofwat already uses it. The report also notes that sub-activity data would be strongly beneficial to the facilitation of competition.

In a previous merger assessment, the Competition Commission also recommended that Ofwat investigate these alternative sources and techniques. If Ofwat were able to make greater use of such information and approaches successfully then over time it is likely that the impact of a loss of a comparator on their approach to cost assessment would decrease. If this were then reflected in assessments of the impact of a merger on the ability of Ofwat to make comparisons, it might correspondingly increase the scope for mergers.

[5] http://www.ofwat.gov.uk/publications/commissioned/rpt_com201105cepapanel.pdf

[6] Panel data refers to the use of more than one year's data in assessing the costs of companies.

Questions for Consideration

Q1. Is the special merger regime still relevant – does Ofwat need to rely so heavily on comparative regulation?

If it can be demonstrated that Ofwat can effectively regulate the sector with fewer comparators there would on the face of it appear to be no reason why the regime should not be relaxed. In deciding whether regulation remains "effective", the benefits to all consumers (served by all companies) of comparative regulation needs to be weighed against the benefits to a sub-set of customers from some companies merging. Ofwat effectively regulate the sewerage sector with 10 comparators – are 21 still required for water? Is there an optimum number of companies needed? Are there already too few comparators on the sewerage side to the detriment of consumers?

The Cave review considered that there were both alternative data and techniques available and in use by other regulatory authorities to support a comparative regulatory approach. Adopting these techniques, such as data envelopment analysis, stochastic frontier analysis and benchmarking, or using alternative data, such as sub-company data and comparators from other industries, would allow Ofwat to continue to use comparative regulation effectively but with fewer comparators. The review considered that this could conceivably allow a loosening of the merger regime.

The Ofwat consultation on Future Price Limits noted that at an industry level, both operating expenditure and capital expenditure outperformance have reduced over time and in the most recent price review period has delivered a 1.6% industry wide operating cost efficiency improvement. This suggests that the effectiveness of the existing comparative efficiency approach may be diminishing.

Q.2 Should the £10m threshold be increased – why?

The Cave review considered that the potential benefits of some mergers may outweigh the detriment resulting from a loss of comparator. Whilst such mergers would be permitted under the existing approach the Cave review considered that the application of the existing Special Merger Regime resulted in a chilling effect on these mergers being proposed.

The review also considered that Ofwat should consider alternative ways to regulate the industry that might require fewer comparators. In addition, a relaxation of the merger regime could help address some of the emerging challenges facing the water industry such as enabling greater optimisation of water resources, particularly in the water stressed South East.

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

The Cave review recommended that the threshold be increased to a maximum of £70m. This would put it in line with the normal merger regime and would enable a small number of companies (7) to merge or be taken over without a referral to the Competition Commission.

There were mixed views on amending the threshold in response to the consultation on the Cave review merger reforms – increasing the threshold to £70 million was generally accepted by large companies with a turnover in excess of £70 million and rejected by smaller companies with a

turnover of less than £70 million.

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

Should there be a threshold test at all? The threshold in the 1991 Water Industry Act for mandatory reference to the CC was £30m in terms of asset value. Under the Enterprise Act 2002, this was changed to a £10 annual turnover test – relating to both the business being taken over and the company proposing the takeover. As such the provisions cover virtually all mergers in the water sector.

The £70 million threshold in the wider merger regime is one of two tests – the other being the 25% share of supply test. The share of supply test tends to capture most mergers that are investigated by the OFT and the CC.

Is there an optimum number of comparators? Should the special merger regime only seek to protect this number of comparators? Should the special merger regime only apply to mergers between the 10 water and sewerage companies? This will ensure that all sewerage mergers would be captured but it could also mean the loss of important water supply comparators. Should some other test be applied to capture important water supply comparators, if so, what?

In taking forward a change to the threshold requirement, it should be pointed out that mergers not eligible for referral under the special merger regime (including mergers between and with new entrant licensees) may still be referred by the OFT to the CC for an assessment under the size of market test in the ordinary merger regime (e.g. if an actual or potential merger will result in the merged entity controlling 25% of more of a defined market).

The OFT has a wide discretion in describing the relevant goods or services, requiring only that, in relation to that description, the parties' share of supply or acquisition is 25% or more. The share of supply is different from a market share, and goods and services to which the share of supply test is applied need not amount to the market defined for the economic analysis. In addition, OFT may have regard to any reasonable description of a set of goods or services to determine whether the share of supply test is met – the value, cost, price, quantity, capacity, number of workers employed or any other criterion may be used to determine whether the 25% threshold is reached.

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

The Cave review did not monetise any specific costs and benefits associated with reform of the regime and proposed that Government should, with stakeholders, reconsider the costs and benefits of the regime. Clearly it is difficult to monetise any costs and benefits as it is not known which companies might merge. However, potential benefits could include :

- increased economies of scale;
- greater capital market pressure leading to efficiency savings;

- lower financing costs (because small firms tend to face a premium on borrowing);
- greater optimisation of water resources where neighbouring companies merge; and
- avoidance of some costs associated with a merger, e.g. from CC referral.

To date only one water merger between Mid-Kent Water and South East Water has taken place since the regime was last changed in 2004 , although a merger between South Staffordshire Water and Cambridge Water has recently been referred to the Competition Commission.[7] This makes it particularly difficult to quantify the value of any potential benefits. In the merger between Mid Kent Water and South East Water much of the financial information, particularly in respect of capital expenditure savings, was excluded from the CC final report under section 244 of the Enterprise Act 2002 (commercially sensitive information). The CC concluded that the merger should proceed on the basis that it found limited detriment to water customers, which was more than offset by the benefits that the merger would bring.

The merger was also expected to result in improved water resource sharing and planning across what were previously company boundaries. However, we are not aware of any evidence that supports or denies the achievement of these expectations and would welcome such evidence from this or any other water sector merger.

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

In the Mid Kent Water and South East Water merger, using Ofwat's current methodology the CC found that the net present value of the customer detriment from one type of prejudice (the 'precision prejudice') from the loss of a generalised comparator was £9 million for operating expenditure and £1.3 million respectively for capital maintenance expenditure. In the Mid Kent Water and South East Water merger, the merging parties were atypical so the CC found that the specific loss of these comparators was £0.3 million and £0.9 million for operating expenditure and capital maintenance expenditure respectively. The CC therefore concluded that a behavioral remedy in the form of a one-off lump-sum reduction of £4 million in bills to customers of Mid Kent Water and South East Water was appropriate, although it also considered structural remedies.

Furthermore, the CC calculated the impact of the loss of a comparator on the confidence intervals (i.e. the statistical precision) of Ofwat's operating and capital expenditure models. This suggests the impact of the loss of a single comparator rises as the number of comparators falls: for example, when Ofwat's models have around 20 comparators (as at present) the loss of a single comparator reduces their precision by around 3%. The CC concluded that a loss in precision in Ofwat's current models from the loss of one comparator of this magnitude "was likely to be small". As the number of comparators falls to 15, however, the loss of a single comparator reduces the precision of Ofwat's operating and capital expenditure models by around 4%.

However, the CC also found "there to be scope for exploring the use of both sub-company data, and, in particular panel data. There might also be scope to ensure that Ofwat made the maximum use of available data from other sources and to use alternative techniques such as

[7] http://www.competition-commission.org.uk/our-work/south-stafford-cambridge-water

stochastic frontier analysis (SFA) and date envelopment analysis (DEA) to validate the results of Ofwat's existing econometric models where possible.[8]

Lifting the threshold would allow the merger of smaller companies without offsetting remedies to address any detriment. The cost of this detriment under Ofwat's present approach to comparative regulation could be of the order of magnitude set out above, although it should be noted that in the Mid Kent Water and South East Water merger the CC found that the merger had given rise to only one of the four possible prejudices that it considered, the precision prejudice. The actual cost of any other merger would therefore depend not only on the specific impact of that merger on the precision prejudice but may also involve one or more of the other three types of prejudice that the CC considered

While the special merger and wider regimes were not set up to consider such issues, there is concern that a relaxation of the regime could potentially lead to inefficient mergers. The SMR does not prevent mergers between water companies - it merely requires that the benefits from a merger exceed the harm caused by the loss of a comparator or that a sufficient remedy is adopted to offset the loss of a comparator. Clearly it is not in the intention of water companies or shareholders to undertake an inefficient mergers but there is a risk that the merging companies may not be able to exploit proposed economies of scale or realise savings in relation to the consolidation of backroom functions.

A number of studies have tried to estimate the minimum efficient scale of water companies in England and Wales. For example, Ofwat commissioned a report on the optimum size for water companies in England and Wales as part of its evidence to the inquiry into the merger between Vivendi Water UK plc and First Aqua (JVCo) Ltd[9]. The paper concluded that no further economies of scale in the water industry were realisable once companies exceeded 400,000 connected properties. Other research has also concluded that no further economies of scale were realisable in relation to the provision of network services and that all, bar the smallest water only companies, were already operating with diseconomies of scale. Potential cost could include:

- diseconomies of scale; and
- loss of comparators.

However, research has also noted that there are potential efficiencies to be gained on the retail-side of network businesses through mergers. This can be attributed to the following:

Presence of economies of scale in retailing

The nature of the retail market in England

A number of studies have noted that retailing is characterised by some significant economies of scale. For example, in its relative efficiency assessment, Ofwat modelled the cost of retailing and found that the coefficient for the number of billed properties was 0.879.[10] This indicates that for every additional customer, the cost of retailing activities increases by less than one (i.e

[8] Competition Commission: South East Water Limited and Mid Kent Water Limited: a report on the completed merger of South East Water Limited and Mid Kent Water Limited 2007.

[9] http://www.ofwat.gov.uk/pricereview/pr04/pr04phase1/rpt_com_econofscale.pdf

[10] http://www.ofwat.gov.uk/publications/pricereviewletters/ltr_pr0939_appendix2.pdf

doubling the customer base would not result in double the cost).

This benefit was acknowledged in the South East and Mid Kent merger, whereby it was noted that rationalising customer service functions, such as call centre arrangements, could generate savings. This was also acknowledged by Deloitte which noted that there are significant economies of scale in retailing.[11]

[11] Deloitte, Lessons for the water and sewerage industry from retail competition in the utility sector, 2011, p40 http://www.deloitte.com/view/en_GB/uk/industries/eiu/water/24dca3dd6f90e210VgnVCM2000001b56f00aRCRD.htm

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