

Water Merger References: Competition Commission Guidelines December 2004 This is one of a series of documents which the Competition Commission is required to publish under the Enterprise Act 2002

# Water Merger References: Competition Commission Guidelines

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## **Part 1: Introduction**

## Purpose of guidance

- This guidance forms part of the advice and information published by the Competition 1.1. Commission (the Commission) under section 106(3) of the Enterprise Act 2002 (the 2002 Act). It explains how the Commission intends to address the questions it is required to answer in respect of water merger references made to it under section 32(a) or (b) of the Water Industry Act 1991 (the WIA). In this guidance we refer to such references as water merger references.
- 1.2. Information on procedural aspects of the Commission's investigations can be found in CC1 Competition Commission: Rules of Procedure (the Rules)<sup>2</sup> and CC4 General Advice and Information. Information about these and other publications of the Commission and the Office of Fair Trading (the OFT) relevant to merger inquiries can be found in the annex to this document.
- This guidance reflects the views of the Commission at the time of publication. It is 1.3. based upon current market conditions of the water<sup>3</sup> industry and the functions of the Director General of Water Services (DGWS)<sup>4</sup> at the date of publication. These may change, as may the water industry, economic theory, the legal context, best practice and the use made by the DGWS of comparisons between water enterprises. New guidance may be published from time to time to reflect such change or the Commission's experience in applying the new regime. In addition, the Commission's approach may change if the Secretary of State exercises her power to make regulations for matters to which the Commission may or must have regard in deciding whether to take any remedial action. 5 This guidance may be revised in the light of any such regulations.
- In addressing the questions which the Commission<sup>6</sup> must answer in respect of water 1.4. merger references, the Commission will consider each case on its facts, applying the statutory provisions in force at the time. It will have regard to this guidance but this guidance is not binding and its application depends on whether it is appropriate to the case in hand.
- Part 3 of the 2002 Act applies to a merger of two or more water enterprises. This 1.5. quidance applies only to water merger references where the Commission applies a different test from that applied in normal mergers. Some mergers may include both water enterprises and other enterprises. For guidance on the Commission's approach to any other parts of the merger (ie the non-water enterprises elements of a

<sup>&</sup>lt;sup>1</sup>Section 106(3) applies to water merger references by virtue of regulation 28 of SI 2004/3202 The Water Mergers (Modification of Enactments) Regulations (The Water Mergers Regulations) which come into force on 29 December 2004.

<sup>&</sup>lt;sup>2</sup>Reference in this guidance to Rules is to the Rules last published on the Commission's web site: www.competitioncommission.org.uk.

References to water include water and sewerage.

<sup>&</sup>lt;sup>4</sup>In this guidance we refer to the regulator as the DGWS. Section 34 of the Water Act 2003 contemplates the regulator being replaced by the Water Services Regulation Authority (the Authority). Once that happens, which is scheduled for 1 April 2006, references in this guidance to the DGWS should be read as references to the Authority.

<sup>&</sup>lt;sup>5</sup>The power to make such regulations is provided in paragraphs 1 together with 4(3) of Schedule 4ZA to the WIA, inserted as Schedule 6 to the WIA by section 70 of the Act. In December 2004 no such regulations had been made.

6In respect of each reference, a group is appointed to carry out the Commission's functions. For further information about the

appointment of groups and the procedures that apply, see CC1 *Rules* and CC4 *General Advice and Information*. <sup>7</sup> 'Water enterprise' is an enterprise carried on by a company appointed under section 6 of the WIA to be a water undertaker or a

sewerage undertaker (sections 6 and 35(1) of the WIA, the latter inserted by section 70 of the 2002 Act and amended by paragraph 27(2) of Schedule 7 to the Water Act 2003).

merger involving both water and other enterprises, which would include the application of the substantial lessening of competition test), see *CC2: Merger References: Competition Commission Guidelines*.

## Water merger references

- 1.6. The OFT is subject to a duty to refer mergers between two or more water enterprises to the Commission<sup>8</sup> if the OFT believes that it is or may be the case—
  - (a) that arrangements are in progress, which, if carried into effect, will result in a merger of any two or more water enterprises; or
  - (b) that such a merger has taken place.
- 1.7. The duty does not apply if the value of the turnover of the water enterprise being taken over or the value of the turnover of each of the water enterprises belonging to the person making the takeover does not or would not exceed £10 million.<sup>9</sup>
- 1.8. The value of the turnover of the water enterprise being taken over is calculated by aggregating the total value of the turnover of the water enterprises which cease to be distinct and deducting—<sup>10</sup>
  - (a) the turnover of any water enterprise continuing to be carried on under the same ownership and control; or
  - (b) if there is no water enterprise continuing to be carried on under the same ownership and control, the turnover which, of all the turnovers concerned, is the turnover of the highest value.

## The questions to be decided in relation to water merger references

- 1.9. The first questions the Commission has to answer in respect of an anticipated water merger are: 11
  - "(a) whether arrangements are in progress which, if carried into effect, will result in a water merger; and
  - (b) if so, whether that merger may be expected to prejudice the ability of the Director, in carrying out his functions by virtue of [the WIA], to make comparisons between different water enterprises."
- 1.10. The first questions the Commission has to answer in respect of a completed water merger are: 12
  - "(a) whether a water merger has taken place; and

<sup>&</sup>lt;sup>8</sup>Section 32 WIA as substituted by section 70 of the 2002 Act. This section does not extend to Scotland.

<sup>&</sup>lt;sup>9</sup>Section 33(1) WIA as substituted by section 70 of the 2002 Act.

<sup>&</sup>lt;sup>10</sup>Section 33(2) WIA as substituted by section 70 of the 2002 Act. SI 2004/3204 The Water Mergers (Determination of Turnover) Regulations 2004 set out details of how to calculate turnover.

<sup>11</sup> Section 36(1) of the 2002 Act as modified by regulation 11 of The Water Mergers Regulations (regulation 11). See paragraph 1.15 below for definition of a water merger.

<sup>&</sup>lt;sup>12</sup>Section 35(1) WIA as modified by regulation 11.

- (b) if so, whether that merger has prejudiced, or may be expected to prejudice, the ability of the IDGWS1, in carrying out his functions by virtue of this IWIA1 Act, to make comparisons between different water enterprises."
- In relation to anticipated mergers, there is a prejudicial outcome if the water merger may be expected to prejudice the ability of the DGWS to make comparisons between different water enterprises, and in relation to completed mergers, there is a prejudicial outcome if the water merger has prejudiced or may be expected to prejudice that ability. 13
- If the Commission decides that there is a prejudicial outcome, it must decide the following additional questions: 14
  - "(a) whether action should be taken by [the Commission] under section 41(2) [of the 2002 Act] for the purpose of remedying, mitigating or preventing the prejudice to the [the DGWS] or any adverse effect which has resulted from, or may be expected to result from, the prejudice to the [DGWS]:
  - (b) whether [the Commission] should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the prejudice to the [DGWS] or any adverse effect which has resulted from, or may be expected to result from, the prejudice to the [DGWS]; and
  - (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented."
- If in the case of a completed merger reference the Commission is satisfied that the reference was not made within the prescribed four-month period, 15 the Commission must state that fact in its report and may not take remedial action. 16
- Part 1 goes on to describe the conditions that constitute a water merger, Part 2 describes how the Commission will consider what constitutes prejudice, and Part 3 describes how the Commission will consider remedies.

#### Water merger

A 'water merger' is a merger of any two or more water enterprises, <sup>17</sup> a water enterprise being an enterprise carried on by a company appointed under section 6 of the WIA to be a water undertaker and/or a sewerage undertaker. 18 A merger of two or more water enterprises is a reference to those enterprises ceasing to be distinct.

## Water enterprises ceasing to be distinct

Any two water enterprises cease to be distinct if they are brought under common ownership or common control (whether or not the business to which either of them formerly belonged continues to be carried on under the same or different ownership or control). Sections 26 and 27 of the Act describe the particular circumstances in

<sup>&</sup>lt;sup>13</sup>Sections 35(1)(b) and 36(1)(b) of the 2002 Act as modified by regulation 11.

<sup>&</sup>lt;sup>14</sup>Sections 35(5) and 36(4) of the 2002 Act as modified by regulation 11.

<sup>&</sup>lt;sup>15</sup>That is, four months from the date of the merger or, if it is later, the day on which the material facts about the merger first come to the attention of the OFT or are made public (section 24 of the 2002 Act as modified by regulation 4). 

16 For more information, see paragraphs 3.2 and 3.3.

<sup>&</sup>lt;sup>17</sup>Paragraph 8 of Schedule 4ZA to the WIA inserted by section 70 of the 2002 Act.

<sup>&</sup>lt;sup>18</sup>See footnote 7.

which enterprises must be treated as being under common control, when a person or group of persons may be treated as bringing an enterprise under his or their control, and how the time when enterprises cease to be distinct is decided when control is transferred by stages. <sup>19</sup> Section 29 of the Act specifies the circumstances in which a series of transactions may, if the Commission considers it appropriate, be treated for the purposes of the reference as having occurred simultaneously on the latest date they occurred.

## EC Merger Regulation

- 1.17. Mergers between enterprises whose combined turnover exceeds the thresholds set in the EC Merger Regulation (ECMR)<sup>20</sup> will have a 'community dimension' giving the European Commission exclusive competence to apply the provisions of the ECMR. Under Article 21 of the ECMR, member states may not apply their national legislation on competition to mergers which fall within the ambit of the ECMR. As an exception to this general prohibition, however, member states may take appropriate measures to protect legitimate interests other than those taken into consideration by the ECMR itself, provided that the measures are compatible with the general principles and other provisions of EC law. By a decision of 29 March 1995 (the EC Decision), the European Commission recognized the legitimate interest of the UK in applying sections 32 to 34 of the WIA, subject to the provisions set out in the EC Decision itself.
- 1.18. The EC Decision was taken in the context of the proposed acquisition by Lyonnaise des Eaux SA of Northumbrian Water Group PLC. At that time, sections 32 to 34 of the WIA applied a qualified public interest test to water mergers. However, the EC Decision was not limited to that transaction alone and recognized that the UK has a legitimate interest in maintaining sufficient comparators in the water industry to enable effective regulation. While the European Commission continues to recognize the maintenance of sufficient comparators as a legitimate interest for the purposes of Article 21, the Competition Commission will continue to receive references relating to mergers that have a community dimension. Consequently, where appropriate this guidance refers to the provisions of the EC Decision to illustrate the approach taken by the European Commission to date.
- 1.19. In these cases, the OFT will refer the merger to the Commission under the normal route of either subsection section (a) or (b) of section 32 of the WIA.
- 1.20. The period in which the Commission must prepare and publish its report is the same as for references made by the OFT under sections 22 or 33 of the Act. For more information about the time limits and procedures, see *CC4: General Advice and Information* paragraph 6.7.

<sup>&</sup>lt;sup>19</sup>These sections apply to water merger references pursuant to paragraph 1 of Schedule 4ZA to the WIA inserted by section 70 of the 2002 Act.

<sup>&</sup>lt;sup>20</sup>EC Merger Regulation means Council Regulation (EEC) No 4064/89 as amended or Council regulation (EC) No 139/2004 as applicable.

# Part 2: Prejudice to the DGWS's ability to make comparisons between different water enterprises

#### Introduction

- 2.1. The second question the Commission has to decide is whether the water merger has prejudiced, or may be expected to prejudice, the DGWS's ability, in carrying out his functions under the WIA, to make comparisons between different water enterprises.
- 2.2. A water merger brings under common ownership or common control two or more water enterprises. The merging water enterprises must continue to operate under separate licences (referred to in the WIA as the instrument of appointment) unless their licences are modified, which would require the DGWS's approval. In the absence of licence changes, the DGWS will continue to receive separate information from each of the merging water enterprises and can continue to use this to make comparisons. This is because, in general, the Commission considers that companies under common ownership may be expected to behave in similar ways and hence that a water merger may be expected to affect the value of comparisons made by the DGWS.
- 2.3. In each case, the Commission will assess whether the impact of the merger on the DGWS's ability to make comparisons is, or may be expected to be, adverse and significant enough to amount to prejudice. Paragraphs 2.8 to 2.14 explain briefly the main areas where the DGWS makes comparisons, and paragraph 2.16 sets out the factors that the Commission may take into account in its assessment. First, however, the effect of the EC decision of 29 March 1995 has to be considered (see paragraphs 1.17 and 1.18 above).

## **Application of EC Decision of 29 March 1995**

2.4. Paragraph 5 of the EC Decision states:

"In order not to go beyond the interest pursued by the UK regulatory legislation other issues in relation to mergers between water companies can only be taken into account to the extent that they affect the control regime as set out above. These other issues would principally include the allocation of cost savings arising from the merger or the effect of the merger on the level of water charges and which would be used in the calculation of the pricing formula for the merged company. By contrast, the UK authorities are not entitled to consider other matters which the [European] Commission must take into account in assessing concentrations that have a Community dimension and which do not directly relate to the operation of the regulatory regime."

- 2.5. As explained in Part 1, at the time of the EC Decision, the test to be applied by the Commission was a qualified public interest test. When applying the new 'prejudice to the DGWS's ability to make comparisons' test, the Commission's approach to water merger references as described in this Part will, in cases where it applies, accord with the requirements of the EC Decision.
- 2.6. Paragraph 6 of the EC Decision provides that:

- "... the implementation of this legislation must not be carried out in a discriminatory manner. The minimum number of independent water companies should therefore not be higher than necessary to ensure the effective operation of the regulatory regime in order to be appropriate and proportional to the objective in question."
- 2.7. Consequently, where the Commission has jurisdiction over water mergers with a community dimension, the Commission will be guided by the need to maintain the minimum number of independent water enterprises necessary to ensure the effective operation of the regulatory regime, and thus to ensure that the UK authorities apply sections 32 to 34 of the WIA in a manner which is non-discriminatory, appropriate and proportionate to the objectives of the legislation, subject to the general principles and other provisions of EC law.

## Use of comparators by the DGWS

- 2.8. The DGWS is responsible for the economic regulation of the water industry in England and Wales. Section 2 of the WIA<sup>21</sup> imposes duties and confers powers on the Secretary of State for Environment, Food and Rural Affairs (the Secretary of State for the Environment) and the DGWS. Their primary duties are to exercise and perform their powers and perform their duties in the manner they consider best calculated to secure that the functions of water enterprises are properly carried out in every area of England and Wales and to secure that such enterprises are able to finance the proper carrying out of their functions. Their secondary duties include protecting customers' interests, promoting economy and efficiency on the part of water enterprises and facilitating effective competition, where appropriate, between water enterprises.
- 2.9. One of the main instruments of economic regulation is the provision in each company's licence for a cap on annual price movements. Under the current licence provisions the DGWS sets this for each water enterprise for a five-year period following a price review (known as the periodic review). The first periodic review covered the years 1995/96<sup>22</sup> to 1999/2000, the second periodic review covered 2000/01 to 2004/05 and the current periodic review covers 2005/06 to 2009/10. A company wishing to dispute the DGWS's determination of its price cap may appeal to the Commission for a redetermination.
- The DGWS bases his determinations of the companies' price caps on projections of 2.10. the companies' costs for the period concerned. Under the general approach used by the DGWS (and also the Commission) in previous periodic reviews and used for the current one (covering 2005/06 to 2009/10), price caps are set so that each regulated business is projected to earn revenue equal to the total of projected operating costs. projected depreciation, projected infrastructure renewals charge<sup>23</sup> and tax plus the cost of capital on projected regulated capital value. The DGWS's efficiency assessments enter in the following ways:

<sup>&</sup>lt;sup>21</sup>The precise duties will be amended when section 34 of the Water Act 2003 is commenced and the WRSA is set up, scheduled for 1 April 2006. <sup>22</sup>1995/96 means the 12-month period starting 1 April 1995.

<sup>&</sup>lt;sup>23</sup>Infrastructure renewals charge is charged on underground assets, which are subject to renewals accounting, and depreciation is charged on other assets.

- (a) The DGWS's operating cost projections for each company take into account both its historical level of costs and an assessment of its efficient level of operating costs<sup>24</sup> based on econometric modelling of all water companies' performance.
- (b) The DGWS's projections of depreciation, infrastructure renewals charge and regulated capital value are affected by the DGWS's projections of each company's required capital expenditure on maintaining and enhancing its assets:
  - (i) The DGWS's projections of capital expenditure on maintenance take into account the historical level of expenditure by the company, the DGWS's assessment of whether this is sufficient to maintain serviceability of its network and the DGWS's assessment of the efficiency of the company's capital maintenance expenditure, which is informed both by econometric modelling and by a comparison of companies' costs for various standard asset works (known as the 'cost base').
  - (ii) The DGWS's projections of capital expenditure on enhancement are based on his assessment of the projects that are needed and the cost of implementing them; the DGWS adjusts the companies' figures for efficiency, using the cost base, and may also challenge them for scope and consistency, for instance where one company's general approach can be demonstrated to be inferior to that of another company.

This is a condensed summary of price cap methodology.<sup>25</sup> The DGWS's present approach is set out in detail in his methodology papers for the current periodic review.

- 2.11. Comparisons between companies play an important role in the DGWS's determination of price caps for two reasons. First, the DGWS uses comparisons of companies' approaches and their estimated capital costs to help estimate the efficient future level of capital expenditure. Second, the DGWS uses econometric modelling of companies' historical operating costs, together with estimates of future efficiency improvements, to estimate the efficient level of future operating expenditure. (The DGWS also makes some use of econometric modelling of capital maintenance expenditure.) Econometric modelling is used to adjust for differences between companies (eg due to geography and heritage) which affect operating costs. The number of comparators is of particular importance to econometric modelling since its statistical robustness depends on the number of observations.
- 2.12. At periodic reviews, comparisons between companies are an important aid to the DGWS in projecting costs rather than a source of direct competition between companies. The DGWS's approach to water regulation is not an example of pure yardstick or comparative competition since a company's price cap is affected by its own costs as well as other companies' costs.<sup>26</sup> For example, at the 2000/01–2004/05 periodic review, the DGWS set price caps broadly on the basis that each company would reduce operating costs over five years by about 60 per cent of the excess of its own costs over the adjusted costs of the company at the frontier of efficiency. (Thus in the first year price caps were assumed to reduce by about 12 per cent of the

<sup>&</sup>lt;sup>24</sup>In addition, allowance is made for any operating costs associated with new requirements which are not reflected in the historical data.

<sup>&</sup>lt;sup>25</sup>Ofwat, as part of its duty to secure companies' ability to finance functions, has also set out an approach to financeability and a securing access to capital markets at reasonable rates.

<sup>&</sup>lt;sup>26</sup>Under pure yardstick regulation, a company's price cap reflects only the costs of other comparable companies (A Shleifer, *A theory of yardstick competition*, Rand Journal of Economics, Autumn 1985).

excess). Furthermore, the DGWS's approach sets price caps for the most efficient company on the basis of its own costs together with an estimate of the reduction in costs due to forecast improvements in the efficiency frontier.<sup>27</sup> This is in contrast to pure yardstick regulation where the most efficient company's price cap reflects other comparable companies' costs and hence it earns profits over and above the cost of capital, equal to the difference between its own costs and the costs of the comparator companies. Under the DGWS's approach, companies' incentive to reduce costs results principally from the price cap being fixed for five years (so that companies retain any cost savings compared with the DGWS's projections for five years<sup>28</sup>).

- 2.13. The DGWS makes annual comparisons of the quality of companies' customer service and relative performance is reflected in an adjustment to price caps. Companies' price caps for 2000/01 to 2004/05 included adjustments of +0.5 per cent (for companies with the highest quality of service) to -0.5 per cent (for companies with the lowest quality of service).
- 2.14. The Commission considers that the advantages to the DGWS of comparisons go beyond the effects on setting price caps at periodic reviews. The DGWS publishes tables comparing companies' performance on various matters including quality of customer service and relative efficiency, and companies may be concerned about their position in these tables and stimulated to seek improvements. Second, comparative information is useful to the DGWS in appraising company proposals in a variety of areas, including tariffs, leakage and transfer pricing, and may enable the DGWS to negotiate improved proposals that better fulfil his functions.

## Effects of the merger on the value of the DGWS's comparisons

- 2.15. The Commission considers that an increase in common ownership or control across one or more companies may be expected to affect the value of the DGWS's comparisons for the following reasons:
  - (a) A reduction in the extent of independent ownership may reduce the reliance the DGWS can place on efficiency comparisons in setting price caps and, given the need to ensure that water companies can finance their functions, lead him to set higher price caps (for all companies) than would otherwise be the case.
  - (b) To the extent that the DGWS can place lesser 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) A reduction in the extent of independent ownership may also be expected to affect the wider use by the DGWS of comparisons for benchmarking purposes.

The Commission may need to consider whether it would be practicable and costeffective for the DGWS to use alternative methods of comparison to offset partially or wholly the effects of the merger on his comparisons through developing comparative

<sup>&</sup>lt;sup>27</sup>The DGWS's current methodology does provide additional rewards for the most efficient companies if they out-perform against expected costs. See *A further consultation on incentive mechanisms: Rewarding future out-performance and handling under-performance of regulatory expectations*, OFWAT consultation paper, 24 June 2003, and *Our conclusions on rewarding out-performance and handling under-performance*, MD 191, 25 March 2004

<sup>&</sup>lt;sup>28</sup>Cost savings made towards the end of the five-year period are maintained for five years through an incentive allowance.

methods which are less sensitive to the number of comparators than those currently used.

- 2.16. In assessing the impact of the merger on the value of the DGWS's comparisons, the Commission will take into account the following factors, which are discussed in paragraphs 2.17 to 2.22 below:
  - (a) the extent of common ownership or control (2.17);
  - (b) any other factors suggesting that the companies involved in the merger could remain to some extent under independent management after the merger (2.18);
  - (c) the extent to which the costs of one or all of the merging companies are, before the merger, not independent of the costs of other water companies (2.19);
  - (d) any particular similarities between the companies involved in the merger (2.20);
  - (e) whether the company or companies being taken over are among the most efficient, for example the loss of a frontier or price-setting company might mean that the DGWS would have to set softer price targets for the whole industry (2.21); and
  - (f) the number and quality of remaining independent comparators (2.22).

The Commission will also take into account any other relevant factors.

- 2.17. A transaction may qualify as a water merger but significant interests may continue to be held after the merger by other parties in one or more of the companies involved in the merger. This could make it more likely that the companies continue under independent management after the merger (for instance, as a result of the existence of a shareholder agreement) and hence less likely that the merger prejudices the ability of the DGWS to make comparisons.
- 2.18. Similarly, the Commission will also consider any other factors suggesting that the companies would continue to some extent under independent management after the merger, and whether this reduces the impact on the DGWS's comparisons.
- 2.19. Furthermore, where aspects of the operation of one or more of the companies involved in the merger are, before the merger, not independent of other water companies, the effect on the DGWS's comparisons is likely to be less than otherwise. This may be the case where a company's choice of similar operating techniques, methods, technologies or management tools to other water companies might have partly diminished the value of one or all the merging companies as a comparator. A possible example is if the operations are contracted out to another water company. Nevertheless, the Commission considers that, in general, comparisons are likely to be more problematic where there is common management than where there is contracting out to another company.
- 2.20. Where merging companies have specific similarities which are not shared by other water companies, comparisons are likely to be of special importance to the DGWS and are likely to have a greater impact on the DGWS's comparisons. For example, comparisons of similar-sized companies are likely to be particularly valuable as may be those with similar geological and other conditions.

- 2.21. The DGWS's price caps are partially based on costs of the most efficient companies. Hence, a merger affecting one or more of the most efficient companies is likely to be of greater significance to the DGWS's comparisons, at least in the short term. Of course, past performance is not necessarily a guide to future performance; hence it is not only mergers of the most efficient companies that are of concern. Where companies come under common management, they might be expected to adopt the methods of the more efficient individual management, but this will not always be the case. (Price reductions resulting from merger efficiencies are considered further in paragraphs 3.33 and 3.34.)
- 2.22. As noted above (paragraph 2.15(a)), the robustness of econometric modelling decreases as the number of independent observations declines. Generally, the smaller the number of remaining independent comparators, the greater is likely to be the impact of a merger on the quality of the DGWS's comparisons. For this reason, a merger of companies supplying sewerage services (where during 2000 there were only ten comparators, including Glas Cymru which contracts out the management of its sewerage operations to another company) is likely to have a greater impact than a merger that reduces the number of companies only supplying water services (where during 2000 there were 20 independent comparators including Glas Cymru<sup>29</sup>).
- 2.23. In considering the impact of a merger on the DGWS's comparisons, the Commission will take into account all the factors set out above and not just the effect on the robustness of econometric modelling. Hence the impact depends on the circumstances of the merger under consideration and it is not possible to state a minimum number of comparators below which the DGWS's ability to make comparisons would be prejudiced.

<sup>&</sup>lt;sup>29</sup>Excludes one very small company and treats as a single independent comparator three companies which are majority owned by Vivendi Water UK.

## Part 3: Remedial action

#### Introduction

3.1. This part considers remedies, starting with the statutory questions the Commission has to answer for each water merger reference if it has decided that the merger situation has or is likely to have an adverse outcome (see paragraphs 1.9 and 1.10 above). It then describes the matters the Commission will take into account when determining the appropriateness of remedies, and finally how the Commission will take relevant customer benefits into account when deciding on appropriate remedial action.

## The remedy questions

- 3.2. If the Commission has decided on a reference under section 32 of the WIA that there is a prejudicial outcome, then it has to decide the remedy questions (see paragraph 1.12). However, except when the situation described in paragraph 3.3 applies, no action may be taken in respect of a completed merger unless the reference was made within the period of four months beginning with the date of the merger or, if later, the day on which material facts about the merger first come to the attention of the OFT or were made public.<sup>30</sup>
- 3.3. The prohibition on taking action does not apply if the reference could not have been made earlier than four months before the date on which it was made because of the ECMR or anything done under or in accordance with its provisions.<sup>31</sup>
- 3.4. The Commission should first consider whether the Commission itself should take remedial action to remedy the prejudice to the DGWS or any adverse effect which has resulted from, or may be expected to result from, the prejudice to the DGWS'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 3.38 to 3.41 below). The second question is whether the Commission should recommend that remedial action should be taken by others, such as Ministers and regulators, including the DGWS. Such recommendations cannot bind the person to whom they are addressed. They can be additional or alternative to any remedial action taken by the Commission. The third question specifically asks the Commission to address what action should be taken and what it is designed to address.
- 3.5. In deciding these questions, the Commission shall 'in particular have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the prejudice to [the DGWS] and any adverse effects resulting from it'. 32

## Consideration of appropriate remedies

3.6. Although the Commission must always consider the appropriateness of any remedial action, it is unlikely that the Commission would decide to take no 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 Commission might conclude that

<sup>&</sup>lt;sup>30</sup>Regulation 4.

The EC Merger Regulation means Council Regulation (EEC) No 4064/89 as amended.

<sup>&</sup>lt;sup>32</sup>Sections 35(6) and 36(5) of the 2002 Act as modified by regulation 11.

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 the DGWS. However, even in these circumstances, the Commission, having decided that no action should be taken by it, might recommend action to be taken by others.

- 3.7. The WIA enables the Commission, under certain circumstances, to take into account, any relevant customer benefits 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 which may be expected to accrue are substantially more important than the prejudice concerned. This consideration too might lead to the decision that no action should be taken. The circumstances in which relevant customer benefits can be considered, and what constitutes a relevant customer benefit, are described later in this part.
- 3.8. The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. The Commission will consider remedy options proposed by the merger parties and others in addition to its own options. When deciding what an appropriate remedy is, the Commission 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

- 3.9. The Commission 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. The Commission will not require a remedy that it considers is disproportionate in relation to the prejudice to the DGWS's ability to make comparisons or any adverse effects resulting or which are expected to result from such prejudice. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that imposes the least cost or that is least restrictive. In particular, when deciding whether to take action and what action to take in respect of mergers to which the EC Decision applies, the Commission will take into account its obligation to ensure that the action it decides should be taken is not disproportionate to the detriment found.<sup>34</sup>
- 3.10. The Commission will generally include in its consideration of parties' costs the costs of implementing a remedy. However, for completed mergers the Commission 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 Commission will normally expect this risk to have been reflected already in the acquisition price. Since the cost of divestiture was, in essence, avoidable, the Commission will not, in the absence of exceptional circumstances, accept that the cost of divestiture should be considered in the setting of remedies.
- 3.11. Normally costs to the companies of forgone economies will only be considered in the context of relevant customer benefits. Other costs such as environmental costs or the social costs of unemployment will not be assessed by the Commission in its

<sup>&</sup>lt;sup>33</sup>Sections 35(7) and 36(6) as modified by regulation 11.

<sup>&</sup>lt;sup>34</sup>See paragraph 2.7.

- consideration of remedies which are intended to address the prejudice to the DGWS's ability to make comparisons.
- 3.12. The Commission will endeavour to minimize 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 OFT and/or the DGWS in implementing, and monitoring compliance with, any remedies that the Commission may put in place or recommend.

#### Effectiveness of remedies

- 3.13. Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.
- 3.14. 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 OFT, which has responsibility for monitoring compliance, and the DGWS. Other examples of interested parties include competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the OFT's attention any concern that a remedy is not being complied with.
- 3.15. 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 3.9) 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.
- 3.16. 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 the DGWS'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 Commission will tend to favour a remedy that can be expected to show results in a relatively short time period—so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.

## Types of remedies

- 3.17. The Commission will consider either of the following types of remedies:
  - (a) structural remedies that are intended to restore all or part of the status quo ante, for example:
    - prohibition of a proposed merger;
    - divestiture of a completed acquisition; and

- partial prohibition or divestiture (ie covering part of one or more of the merging companies' business); and
- (b) behavioural remedies that are intended to decrease the prejudice to the DGWS's ability to make comparisons and any other adverse effect resulting from the prejudice, for example:
  - amendments to the company's licence, for instance regarding provision of information; and
  - a requirement to maintain separate management or separate accounting arrangements.

## Addressing the prejudice to the DGWS's ability to make comparisons

- 3.18. In addressing the question of which remedies would be appropriate, and would provide as comprehensive a solution as is reasonable and practicable to address the prejudice to the DGWS's ability to make comparisons and any adverse effects resulting from the prejudice, the Commission will take account of how adequately the action would remedy, prevent or mitigate the concerns caused by the merger.
- 3.19. The Commission's starting point will be to choose remedial action that will prevent the prejudice to the DGWS'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 relevant customer benefits that would be forgone may mean that other types of remedy need to be considered. The Commission may decide to impose more than one type of remedy.

#### Prohibition and divestiture

- 3.20. 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 a shareholding in the target company. This will usually need to be reduced to a specified maximum level, below which the Commission judges there could be no possibility of material influence, within a specified and reasonable time period.
- 3.21. For mergers already completed, the most effective remedy may be divestiture of the acquired business. The Commission would expect remedial action, including divestiture, to occur within a specified and reasonable time after the Commission has published its decision. When determining the appropriate period within which divestiture is to be completed, the Commission will seek to balance factors in favour of a shorter period, such as minimizing the impact of competitiveness on the business to be divested, against factors in favour of a longer period such as identifying a sufficient selection of suitable purchasers and facilitating due diligence on their part. 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 Commission will generally insist on having the right to approve the prospective purchaser and the divestiture agreement before the parties may proceed with the

- divestiture. The Commission's approach to the divestiture process is outlined in its Divestiture Guidance (CC8). 35
- 3.22. As an alternative to either prohibition or divestiture of the acquired business, the Commission may consider divestiture of the acquirer's holdings in other water enterprises, where this would appropriately restore the DGWS's ability to make comparisons.

## Partial prohibition and divestiture

- 3.23. 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 the DGWS'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. The Divestiture Guidance outlines the Commission's general approach to defining divestiture packages (see Part 3: Scope of divestiture packages).
- 3.24. There are two key questions that will help to determine whether partial divestiture can be an effective remedy in a water merger case:
  - (a) 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 the DGWS; and
  - (b) 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.

As with other remedies, the Commission will have regard to relevant customer benefits in considering partial prohibition and divestiture.

3.25. As with full divestitures, the Commission would expect remedial action, including divestiture, to occur within a specified and reasonable time after the Commission has published its decision. When determining the appropriate period within which divestiture is to be completed, the Commission will seek to balance factors in favour of a shorter period, such as minimizing the impact of competitiveness on the business to be divested, against factors in favour of a longer period such as identifying a sufficient selection of suitable purchasers and facilitating due diligence on their part. 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 Commission will generally insist on having the right to approve the prospective purchaser and the divestiture agreement before the parties may proceed with the divestiture.

<sup>&</sup>lt;sup>35</sup>CC8 Application of Divestiture Remedies in Merger Inquiries: Competition Commission Guidelines (Divestiture Guidance)—see, in particular, section 5 regarding effective divestiture process.

## Behavioural remedies

The Commission will also consider whether to recommend that action be taken by 3.26. others, in particular the DGWS. This could include changes to the merging companies' price caps and licence conditions requiring the provision of information to the DGWS.

#### Relevant customer benefits

- 3.27. In deciding remedies, <sup>36</sup> the Commission:
  - "... may, in particular, have regard to the effect of any such action on any relevant customer benefits in relation to the merger concerned provided that—
  - (a) a consideration of these benefits would not prevent a solution to the prejudice concerned: or
  - (b) the benefits which have accrued or, may be expected to accrue, are substantially more important than the prejudice concerned."
- Relevant customer benefits are limited to benefits to 'relevant customers' in the form 3.28. of<sup>.37</sup>
  - "(a) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom; or
  - (b) greater innovation in relation to such goods or services."
- Relevant customers<sup>38</sup> 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. It would therefore be a relevant benefit of a merger if, as a result of the merger, a customer in an intermediate market obtained lower prices (or higher quality) whether or not final consumers were likely to benefit.
- In addition to falling within the description of customer benefits described in paragraph 3.27 above, the Commission 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.<sup>39</sup> The burden is upon the merging parties to provide evidence that any claimed benefit does in fact fall within the meaning of a relevant customer benefit.
- The Commission 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.
- 3.32. In the paragraphs below, examples of possible relevant customer benefits are given, followed by an explanation of how they will be taken into account when considering whether any remedial action should be taken.

 $<sup>^{36}</sup>$ Sections 35(7) and 36(6) of the 2002 Act as modified by regulation 11.  $^{37}$ Section 30(1)(a) of the 2002 Act as modified by regulation 6.

<sup>&</sup>lt;sup>38</sup>Section 30(4) of the 2002 Act as modified by regulation 6.

<sup>&</sup>lt;sup>39</sup>Section 30(2) of the 2002 Act as modified by regulation 6.

## Possible relevant customer benefits

- 3.33. A merger can lead to cost savings due to economies of scale in the supply of water and/or sewerage services. The Commission will assess both the extent of the expected cost savings and extent to which any such cost savings can be expected to lead to relevant customer benefits by being passed on to the merged company's customers through lower price caps.
- 3.34. In assessing relevant customer benefits, the Commission will have regard to the timing and relative certainty of the proposed benefits. It is likely that much more weight can be attached to anticipated cost savings which are supported by immediate proposed amendments to companies' price caps.<sup>40</sup> The Commission will consider evidence on the details of how cost savings may be achieved by the merging companies. This will help to show whether or not cost savings are likely to continue beyond the initial five-year period.
- 3.35. A relevant customer benefit may also result from higher quality or greater innovation. Possible examples of higher quality may arise from improved security of supply due to improved coordination between companies or improved service standards due to additional investment partially or wholly outside regulated capital value. However, before deciding that the benefit is a relevant customer benefit, the Commission would have to be satisfied that it would be unlikely to accrue without the merger or a similar prejudice to the DGWS; for example, that it would not be achieved through agreement between the parties.

#### Relevant customer benefits and remedies

3.36. If the Commission is satisfied that relevant customer benefits would result from a merger that also led to an adverse outcome, it will consider whether the prejudice concerned can be remedied, mitigated or prevented while taking these benefits into account or whether these benefits may be expected to be substantially more important than the prejudice. If the first circumstance is applicable, the Commission will, wherever possible, seek to choose remedial action that would not adversely affect the relevant customer benefit. It is difficult to quantify the prejudice to the DGWS's ability to make comparisons and, in most cases, the Commission will therefore make a qualitative comparison of that prejudice and the relevant customer benefits in deciding whether the latter is substantially more important than the former.

## **Undertakings and Orders**

- 3.37. As far as its own actions are concerned, the Commission will have the choice of seeking undertakings from the persons that are to be the subject of the remedial measures or of making an order. A relevant consideration in determining which form to use will be the parties' willingness to negotiate and agree undertakings in the light of the Commission's report. Another will be the scope of the Commission's powers and whether the remedy that it considers appropriate falls within those powers.
- 3.38. The Commission's order-making powers are set out in the Act. Schedule 8 sets out the types of provisions that could be included in an order, and Part 1 of Schedule 9

<sup>&</sup>lt;sup>40</sup>Where amendments to price caps are proposed, the Commission will expect consequential adjustments to be agreed to the terms of the companies' rolling incentive mechanisms. (The DGWS's existing rolling incentive mechanisms are set out in the two documents referred to in footnote 27.)

sets out provision enabling the Commission to modify, by order, licence conditions in various regulated markets. While the content of any orders made by the Commission is limited by the Act, the subject matter of an undertaking is not similarly limited. <sup>41</sup> The process of negotiation that is involved with undertakings and the fact that their content is not limited to the matters contained in Schedule 8 may be advantageous in terms of flexibility and suitability. If the Commission decided to exercise its power to modify relevant licence condition, it would do so by making an order.

- 3.39. In general, the Commission'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 Commission may choose to implement the remedy by way of an order to avoid delay while undertakings are negotiated.
- 3.40. The Commission welcomes the possibility of accepting undertakings that the parties put forward as being those they are willing to enter into and which the Commission considers would provide a comprehensive solution. However, even if the parties do propose undertakings, the Commission may consider alternative remedies.

## Procedural and other aspects of undertakings and orders

3.41. For more information about undertakings and orders and the procedure that applies when remedies are being considered, see *CC4: General Advice and Information*, Parts 6 and 7.

<sup>&</sup>lt;sup>41</sup>Section 89(1) of the 2002 Act as applied to water merger references by regulation 2.

Annex

## Information relevant to the Enterprise Act

## **Competition Commission publications**

www.competition-commission.org.uk

CC1	Competition Commission: Rules of Procedure
	Merger References: Competition Commission Guidelines
CC3	Market Investigation References: Competition Commission Guidelines
CC4	General Advice and Information
CC5	Statement of Policy Penalties
CC6	Chairman's Guidance to Groups
CC7	Chairman's Guidance on Disclosure of Information in Merger and Market Inquiries
CC8	Application of Divestiture Remedies in Merger Inquiries: Competition Commission

## **OFT publications**

Guidelines

www.oft.gov.uk

OFT 508 Overview of the Enterprise Act OFT 516 Mergers: Substantive Assessment OFT 526 Mergers: Procedural Guidance OFT 511 Market Investigation References

## **Competition Appeal Tribunal publications**

Competition Appeal Tribunal Rules www.catribunal.org.uk

## **Department of Trade and Industry Information**

See DTI web site www.dti.gov.uk/ccp

