

Agenda

Advancing economics in business

The case of South Staffordshire/ Cambridge: is clearer water emerging?

In May 2012, the UK Competition Commission cleared a water merger without requiring any undertakings: the first time this has happened in the history of the privatised water sector. Building on previous analysis, the CC changed its approach to valuing the detriments to regulation of the water sector caused by mergers. Along with proposed changes to the merger regime being put forward in the Draft Water Bill, this case should provide clearer guidance to those considering acquisitions in the sector

After privatisation of the sector in 1989, it was considered that the water industry in England and Wales was likely to retain (at least for the foreseeable future) a structure of local regional monopolies, and that the introduction of competition would be more limited than in other regulated industries, notably telecoms, electricity and gas. As such, industry regulator, Ofwat, has relied more heavily on comparative competition than has been the case in other regulated industries. Its regulatory regime was designed to impose quasi-competitive pressures on the water companies by undertaking comparative assessments between them for the purposes of price-setting. These include comparisons of:

- operating cost efficiency;
- capital cost efficiency;
- service and quality performance.

This approach to regulation of the water sector has resulted in an emphasis on the importance of maintaining a sufficient number of independent companies, to preserve the robustness of the comparisons. As a consequence, the Water Industry Act 1991 (as amended by the Enterprise Act 2002) requires that any proposed merger between licensed water companies is automatically referred to the Competition Commission (CC) if the turnover of either party exceeds £10m.¹ This is the only sector of the economy in which mergers are subject to this level of regulatory scrutiny as a matter of law. Furthermore, the CC's remit in a water reference is not to apply the more commonly understood 'substantial lessening of competition' (SLC) test, which applies to mergers in all other sectors, but to assess whether a merger has prejudiced or may prejudice the ability of Ofwat to

make comparisons between water enterprises. There is a widely held view that these prescriptive rules have inhibited potentially efficiency-enhancing mergers between water companies in England and Wales. For example, Professor Martin Cave, in his independent review of competition and innovation in the water industry, concluded that:

The special merger regime represents a significant barrier to further consolidation, adversely affecting the scope for efficiency gains, financing costs and resource optimisation.²

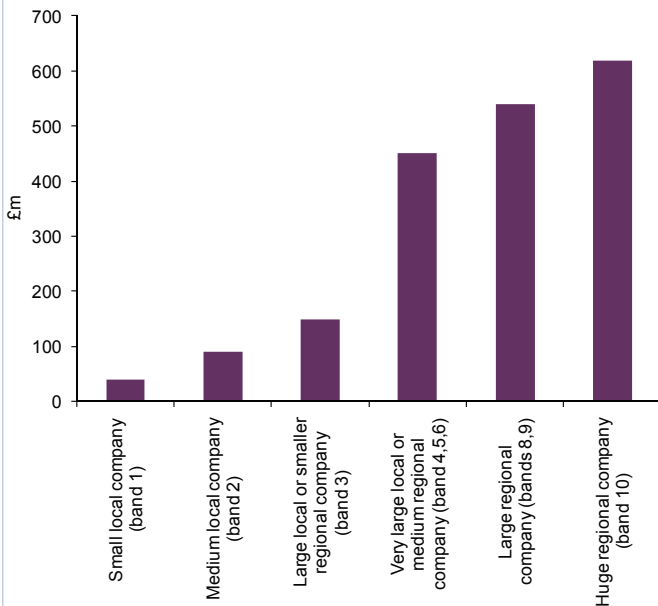
Water merger implications

In examining actual or potential prejudice to the regulatory regime, a central question for the CC is the value of the merging parties to Ofwat as independent companies that provide separate data for the purposes of comparison with the potential value of the merged company. The CC also takes into account the effect of reducing the number of independent comparators available to Ofwat in terms of the impact on consumers. In such cases, the CC considers evidence on this impact submitted by the merging parties and by Ofwat, but also undertakes its own assessment.

In previous cases, Ofwat has taken the position that all mergers in the water sector give rise to 'prejudice', and that the value of losing an independent comparator is potentially significant. It has previously valued the detriment from losing a comparator at around £500m for the larger companies (defined as companies with turnover of £150m or more), with the valuation depending on the size of the company, as illustrated in Figure 1 overleaf.

Oxera acted as economic advisers to South Staffordshire plc. This article was written with assistance from James Aitken, Partner at Freshfield Bruckhaus Deringer, which acted as legal advisers during the case.

Figure 1 Ofwat’s estimated value of an independent water company by size



Note: Values are in net present value (NPV) terms over a period of 25 years.
 Source: Competition Commission (2002), 'Vivendi Water UK PLC and First Aqua (JVCo) Limited: A Report on the Proposed Merger', Appendix 5.4.

The significance of the valuation figures, if accepted by the CC, is that merging parties would need to offer 'remedies' in the form of price reductions of an amount at least equivalent to the value of the detriment, or face their deal being blocked outright. The sums previously quoted by Ofwat are significant and could lead to remedies that could undermine the commercial viability of many potential transactions.

While Ofwat's views have always been important in any merger inquiry, the CC has not always entirely accepted Ofwat's proposed valuations, and, as noted above, has also undertaken its own detailed analysis of these issues.

What was Ofwat's view on this merger?

This latest merger case between South Staffordshire Water and Cambridge Water involved the third- and eighth-smallest water companies. Both are water-only companies with no sewerage business, and they are not contiguous (ie, the regions they serve are not next door to one another geographically). Given their size, many industry observers might have expected the transaction to be subject to a relatively light degree of scrutiny with a limited valuation of any potential remedies. Ofwat maintained its position that, in principle, 'all mergers', including this one, would be prejudicial to the regulatory regime. It provided figures to the CC (based on its previous work in the South East Water/Mid Kent Water merger case in 2006–07³),

which indicated that it estimated the loss of 'a comparator' in respect of operating expenditure alone (ie, only one of several comparisons made by Ofwat) to be 'in excess of £200 million over 30 years'.⁴ It went on to say that it considered that the impact 'would be small given the relative size of South Staffordshire Water and Cambridge Water' and 'would not be sufficient to prevent the merger'. However, given that the total turnover of Cambridge Water in its most recent accounts was £20.2m,⁵ these valuation figures could have undermined the commercial rationale for the transaction, had they been accepted.

During the course of the inquiry, Ofwat updated its valuation analysis. The CC reported that:

Ofwat's analysis shows that the benchmark does not change for 96.5 per cent of scenarios...In 3.5 per cent of cases...the impact of the loss of the target company...[ranges] from £298 million to £527 million.⁶

No explicit impact was attributed to the merger in question. Nevertheless, the reported values of this impact, possibly ranging to hundreds of millions of pounds in respect of even very small transactions, appear to be similar in order of magnitude to those quoted by Ofwat in previous cases.

In the event, the CC did not accept Ofwat's valuations of detriment. The CC's own analysis, based on empirical work provided by the merging parties,⁷ showed that there would be little or no negative impact on the accuracy of the tools used by Ofwat to make the comparisons. In addition, as a result of the merger, the empirical work submitted showed that a comparatively more efficient company would be more likely to become the industry benchmark, thereby benefiting all industry customers. Based on this evidence and its own analysis, the CC decided 'on balance' to clear the merger unconditionally, being satisfied that the overall effect of the transaction would not create any significant detriment.

Indeed, it could be argued that previous valuations of the impact of a merger are now beginning to appear somewhat dated, as a result of Ofwat's move towards a new regulatory regime (focusing on company-specific outcomes and a reduction in the volume of comparative information collated); the increased importance of competition in the sector (and recent confirmation of this in the Draft Water Bill, published on July 10th 2012); and, not least, the CC's most recent conclusions. It is also notable that, in his 2009 report, Professor Cave suggested that change was needed, and that 'the regime [should be] reformed and restricted to those mergers which are likely to have a significant impact on Ofwat's ability to undertake comparative competition'.⁸

The CC's latest approach

The CC's approach in this case was to examine the merger's potential impact on Ofwat's ability to make comparisons between water companies in three broad categories (its 'theories of adverse impact'): Ofwat's ability to use comparisons when setting price limits; to monitor and incentivise service quality; and to identify and spread best practice.⁹ These are examined in turn below.

First, a merger could affect Ofwat's ability to use comparisons when setting price limits. Ofwat makes comparisons between the companies and any impact can be generalised as one of two issues:

- a decline in the *precision* of the comparisons used by Ofwat;
- a weakening of the targets, or the *benchmark*, that Ofwat uses based on those comparisons.

With the former, the CC considered that the loss of a company, and consequent reduced number of observations, can be expected to result in a loss of precision in the comparisons, with a detriment to the efficiency target set for companies by the regulator. It quantified this at between £6.2m and £7.8m in NPV terms over 30 years.

With regard to the weakening of the benchmark, equivalent to Ofwat's figure (discussed above), Oxera estimated the impact of the merger to be a *benefit* for customers of £2.1m (also in NPV terms over 30 years), derived from more stringent efficiency targets for companies and therefore lower prices. The CC agreed that there was a benefit with respect to this impact, and used the estimate as the basis for its own analysis and conclusions.

This area of impact currently covers Ofwat's econometric models of operating cost efficiency, its cost-base analysis of relative efficiency in capital expenditure, and comparisons of the assumptions and projections made by companies (eg, as provided in the companies' Business Plans). Oxera understands that, going forward, Ofwat's approach in these areas will change, so the specific details of how the impact is estimated may also change, although the principles remain pertinent.

Second, a merger could affect Ofwat's ability to use comparisons to monitor and incentivise service quality. The CC deemed the historical reliance on league tables to rank companies' performance in the areas of service quality, reliability and availability, to be effective in incentivising good-quality service.¹⁰ League tables provide companies and their management predominantly with reputational incentives, although the overall performance assessment (OPA) used by Ofwat between 1996/97 and 2009/10 could provide

additional incentives through rewards or penalties applied to the price settlement. Oxera understands that the Service Incentive Mechanism (SIM), which, although focusing only on customer service, replaced the OPA in 2010/11 and was used to compile the league table in that year, is also likely to include financial incentives.¹¹ In general terms, it appears that the potential impact of a merger on the incentives provided by league tables is twofold:

- the approaches available to Ofwat for comparative purposes may be less diverse;
- removing a leading company could reduce the incentives for other companies that benchmark themselves against the leader.

Ofwat has indicated that the SIM may soon be adapted to reflect the existence of separate retail controls for water and sewerage and the interaction with the developing regulatory framework that focuses on outcomes and is developed through closer customer engagement.¹² More generally, with regulation focusing on outcomes identified by companies and their customers, the objectives pursued by companies, and the means used to deliver these, could become more company-specific, thereby making meaningful comparisons of performance more difficult.

However, Ofwat is set to retain the SIM, which will form part of a set of common key performance indicators (KPIs) on which company performance in the areas of customer experience, environmental impact, and reliability and availability may be assessed.¹³

Going forward, it is unclear whether the use of comparisons between companies' performance to provide them with incentives to improve quality of service will be retained. The two areas to consider when assessing the league table implications of a merger therefore remain pertinent.

Finally, a merger could affect Ofwat's ability to use comparisons to identify and spread best practice. This turned out not to be a material issue in this merger case, particularly because the CC considered that Ofwat's comparative approach in identifying and spreading best practice had only limited value.¹⁴

As Ofwat's stated intention is to:

take a more outcomes-focused approach to the way in which [it] regulate[s]. This means focusing on the outcomes that customers want, and holding companies to account for the outcomes they deliver, rather than how they deliver them¹⁵

it appears that the use of comparisons to identify best practice will be further reduced. As such, this is unlikely to be an area of relevance in assessing future mergers.

Future mergers

The Draft Water Bill sets out proposals to reform the water-specific merger regime, including a 'first-phase' screen that will align the procedures for water mergers with those in other sectors of the economy, and open up the possibility that parties will be able to offer remedies 'up front' without having to undergo an extensive CC review process. Furthermore, the reforms propose that Ofwat be required to publish a 'statement of methods', setting out how it values comparators (as discussed below). This is intended to provide guidance to merging parties and the merger control authorities on the valuation of water companies for the purposes of calculating the amount of any required remedies.¹⁶

The Draft Water Bill does not indicate how Ofwat is likely to reach its views on the value of comparators for the purposes of its statement of methods. If Ofwat were to follow its traditional approach (as discussed above), the practical effect of the bill's proposals on merger transactions might not be as significant as some industry commentators are expecting. If, however, it continues to quote high potential detriment valuations, and these are followed by the Office of Fair Trading (or its successor, the CMA), the potential remedies required may be so significant as to outweigh the commercial attractiveness of all but the very largest mergers. As such, Ofwat's guidance will be crucial to future mergers in the England and Wales water industry.

The CC's unconditional clearance of the merger between South Staffordshire Water and Cambridge Water broke new ground and already provides

significant further guidance on how the value of a comparator in the water industry can be assessed. If Ofwat's statement of methods diverges significantly from the CC's analytical framework in this merger, some merging parties may be prepared to 'test' the new statement of methods in a full-scale merger review process before the CC (or the CMA), in order to minimise the cost of any potential remedies that they may otherwise have to give to secure clearance.

Preparing the industry for the challenges ahead

The water industry in England and Wales is undergoing important changes to its structure and regulatory framework. These will help it to face the challenges ahead, such as climate change, weather volatility, population growth, and increasingly stringent environmental standards. An important aspect of this evolution is allowing companies more flexibility to expand and merge their operations. In this context, the new merger regime proposed in the Draft Water Bill requires Ofwat to make transparent, in a statement of methods, how it would value the loss of a comparator.

The CC's recent decision on the merger case provides some indications of the areas that the statement of methods might cover, such as the implications of a merger for Ofwat's ability to use comparisons when setting prices, and its ability to incentivise quality of service. The regulator's ongoing work on reform of regulation in the sector and the evolution of the competition regime are also likely to influence its future approach towards mergers.

¹ This new threshold, introduced under the Enterprise Act 2002, replaces a previous threshold based on minimum assets valued at £30m.

² Cave, M. (2009), 'Independent Review of Competition and Innovation in Water Markets: Final Report', Foreword, April.

³ Competition Commission (2007), 'South East Water Limited and Mid Kent Water Limited: A Report on the Completed Water Merger of South East Water Limited and Mid Kent Water Limited', May 1st. In this case, the CC developed a framework to assess the impact of a merger between two water companies based on four key areas (see footnote 9 below). Oxera acted as economic advisers to Hastings plc, the owner of Mid Kent Water.

⁴ Ofwat (2012), 'Ofwat's Initial Submission to the Competition Commission following the Acquisition of Cambridge Water by South Staffordshire Water PLC', January.

⁵ Ofwat (2012), 'Water companies in England and Wales: financial summary 2010/11', turnover by company, available at http://www.ofwat.gov.uk/regulating/reporting/rpt_fsum2010-11, accessed on August 13th 2012.

⁶ Competition Commission (2012), 'South Staffordshire Plc/Cambridge Water PLC merger inquiry: A report on the Completed Acquisition by South Staffordshire Plc of Cambridge Water PLC', appendix F, para 103, May 31st. An industry benchmark company is an efficient company that can be used as the basis for setting cost-reduction targets for the rest of the industry.

⁷ For details, see South Staffordshire Plc (2012), 'South Staffordshire Plc Acquisition of Cambridge Water Plc – Initial Submission', January.

Oxera (2012), 'The Creation of a Better Comparator Through the Merger of South Staffs and Cambridge, and its Impact on the Industry's Benchmark: a Technical Annex', January.

⁸ Cave (2009), op. cit., p. 4.

⁹ In the South East Water/Mid Kent Water merger case, the CC had four areas of impact (benchmark, precision, cost base, and qualitative comparisons). These are also captured in the latest categorisation.

¹⁰ Competition Commission (2012), op. cit., para 5.153.

¹¹ Ofwat (2012), 'Key Performance Indicators – Guidance', p. 6, March.

¹² Ofwat (2012), 'Future of Price Limits – Statement of Principles', p. 42, May.

¹³ Ofwat (2012), 'Key Performance Indicators – Guidance', March.

¹⁴ Competition Commission (2012), op. cit., para 5.166.

¹⁵ Ofwat (2012), 'Delivering Proportionate and Targeted Regulation – Ofwat's Risk-based Approach', p. 4, March.

¹⁶ The current authorities, the Office of Fair Trading and the CC, are to be merged to form the Competition and Markets Authority, CMA.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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