

Agenda

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Venturing further: water retail consolidation in England

The water sector in England is reshaping itself ahead of the non-household retail market opening in early 2017. There has already been some consolidation among existing players, and a number of others have signalled that they intend to enter the sector. What can be learned from these developments, and what can be expected going forward?

On 3 May 2016, the UK Competition and Markets Authority (CMA) cleared a proposed joint venture (JV) between the non-household retail functions of water companies Severn Trent and United Utilities.¹

This is the first JV to take place between water companies' retail functions, as distinct entities from their wholesale functions. It also represents the first JV between water companies to be assessed under the Enterprise Act 2002 (EA02), rather than under the special merger regime that usually applies to water companies.

This article looks at some of the key contextual considerations for the JV, and what it might mean for future mergers in the sector.

The non-household water retail market

The non-household retail market for water and wastewater services is due to open in England on 1 April 2017. Such a market has already been in place in Scotland since 2008, where it has seen widespread benefits to customers in the form of lower prices and better services.²

The Severn Trent and United Utilities non-household retail JV is not the only recent consolidation seen in the sector. In November 2015 South West Water acquired Bournemouth Water, which included the amalgamation of all the companies' functions, not just their non-household activities. In January 2016 Portsmouth Water and Castle Water announced a JV, with Castle Water due to take sole ownership of the JV's non-household customers from April 2017.³ In June 2016 it was announced that Business Stream (the largest retailer in Scotland) would acquire Southern Water's non-household retail customers.⁴ In July 2016, it

was announced that Castle Water would acquire Thames Water's non-household retail customers.⁵

Wessex Water and Bristol Water have been in a JV for retail services for a number of years. However, the Severn Trent–United Utilities JV is being established in the context of an emerging market, and the companies are signalling⁶ that in due course they will apply to the Secretary of State for consent to exit non-household retail, meaning that they will be able to fully transfer their non-household retail activities to the JV.

The legal framework

Historically, all mergers in the water sector where the turnover of the companies concerned exceeds £10m have been automatically referred to a phase 2 CMA⁷ investigation.

The Water Act 2014 amended this framework such that water mergers could be cleared at phase 1 (albeit with certain additions to the standard process—such as the requirement that Ofwat, the economic regulator of the water industry in England and Wales, provides the CMA with its opinion on whether and to what extent its ability to carry out its functions through making comparisons between water companies is likely to be prejudiced by the merger). However, in this case the JV was not subject to the special merger regime for water, but was assessed under the standard EA02 framework. The EA02 requires a phase 2 referral in cases where the CMA considers that there is a reasonable prospect that the merger in question may result in a substantial lessening of competition.

The CMA chose to clear the JV at the end of phase 1, making it the first JV between two UK water companies (considered

under any framework) with a turnover of over £10m to receive phase 1 clearance.

What did the CMA find?

The CMA's conclusions include the following.

Product scope—based on views provided by prospective market participants, and evidence from Scotland, the CMA considered that the relevant market was for water and wastewater retail services combined (rather than separately).

Customer segmentation—based on similar sources of evidence, the CMA considered that it may be appropriate to segment the market in terms of large users, small and medium-sized enterprises (SMEs), and multi-site customers (customers with multiple properties).

Geographic market—as the Scottish market has already opened, and there may (at least initially) be some regulatory differences with the English market, the CMA chose to consider the English and Scottish markets separately.

Competitive assessment—the CMA found that, while the companies would have been close competitors, they would not have been uniquely close. It found strong evidence that there would be a large number of suppliers competing in the market once it was open, and took advice from Ofwat about the relatively large number of potential entrants. Evidence from the Scottish market also suggested that there would be substantial entry in due course.

Based on the evidence considered, the CMA did not believe that the JV would, or would be likely to, result in a substantial lessening of competition.

Implications for the sector

The implications from the CMA report for the sector include the following.

- Other companies will now have to contend with a large player that has the stated intention of delivering 'an attractive proposition for large and small business customers across England and Scotland'.⁸ The JV will not be the only large player in the market: Castle Water (Thames Water), Business Stream, Anglian Water and Yorkshire Water are all sizeable companies. However, in the absence of any further consolidation,⁹ it will be the largest player when the market opens.
- The JV is likely to trigger strategic responses from other companies. This could take the form of further consolidation, or increased specialisation of what companies have to offer, such that they compete based on a differentiated service offering rather than on scale.
- The fact that there are currently a large number of players (over 30) would have undoubtedly contributed to the CMA's conclusion that the JV would not lead

to a substantial lessening of competition. However, if further consolidation occurs, market concentration could increase, potentially making the CMA more sceptical of future mergers. This could make it more difficult for future JVs in the industry to gain CMA clearance.

- There could be a read-across to the emerging upstream markets (water resources and sludge). Ofwat has proposed to set separate binding price controls for both sludge and water resources at the 2019 price review (PR19).¹⁰ One of the key reasons for doing this is to help facilitate effective markets in these areas. Companies may now be considering JVs for these parts of the value chain. Whether the CMA would consider such mergers under EA02 or under the special merger regime (given their relative asset intensity) is yet to be seen.
- Although this merger was assessed under EA02 (in which Ofwat has no formal role), Ofwat provided significant input to the CMA, with the CMA noting in its decision paper that 'The majority of third parties, including Ofwat, were not concerned by the Merger.'¹¹

Other companies that are interested in consolidation may therefore find it useful to engage with Ofwat in advance, to make sure that any of its concerns are suitably addressed.

What could be the future structure of the industry?

Ofwat has previously considered that there are economies of scale in the provision of retail services,¹² which might suggest that further consolidation among existing players will take place. However, it should be noted that in Scotland a number of relatively small companies have been able to compete effectively.¹³ Furthermore, at the 2014 price review, Ofwat undertook an efficiency assessment of water companies' household retail costs.¹⁴ This assessment identified that a number of the smaller companies had a lower cost to serve than the larger players. While this does not prove in itself that economies of scale do not exist in water retailing, it shows that such economies might not be an insurmountable disadvantage for smaller players.

The gas and electricity supply markets in Great Britain share a number of characteristics with water retailing, and might therefore provide an indication of the future industry structure. These markets have six large companies that together hold around 85% of market share, with many smaller companies making up the rest.¹⁵ This might suggest that there could be further consolidation in the water sector,¹⁶ with a number of smaller players providing more bespoke service offerings.

Further consolidation may also be implied by the CMA's findings on product scope. The CMA defined the market as water and wastewater retailing combined. Ofwat has previously recognised that there are economies of scope between the two services, and made explicit allowance for this within its household retail price controls.¹⁷

There are currently a number of water-only companies in England. Given that there are likely to be economies of scope, we may see water-only companies merging with the wastewater companies that currently serve the same customer base.

A further consideration is potential consolidation across the utility sectors. Indeed, there has already been some crossover here.¹⁸ The potential for utility bundles was envisaged in the impact assessment by Defra (the UK Department for Environment, Food & Rural Affairs) on the introduction of retail competition.¹⁹ This may prove to be a particularly relevant means through which value can be realised, given that some parties consider the existing margins within the sector to be fairly low.²⁰

Conclusions

The Severn Trent–United Utilities non-household retail JV is the first of its kind, in terms of both its legal structure and the fact that it is a JV between UK water companies (considered under any framework) with a turnover of over £10m that was cleared at phase 1 by the CMA. In the coming months we are likely to see a range of strategic responses from the rest of the industry. If competition works effectively, consumers will benefit. It will nonetheless be important for Ofwat to keep track of market dynamics and consumer outcomes after April 2017.

¹ Competition and Markets Authority (2016), 'Anticipated non-household retail water and sewerage services joint venture between Severn Trent Plc and United Utilities Group Plc: Decision on relevant merger situation and substantial lessening of competition', ME/6575/15, 27 May, <https://www.gov.uk/cma-cases/severn-trent-united-utilities-merger-inquiry>. Oxera provided economic advice to the two parties.

² Water Industry Commission for Scotland (2010), 'Competition in the Scottish water industry: achieving best value for water and sewerage customers 2009–10', December, <http://www.watercommission.co.uk/UserFiles/Documents/Competition%20report%20-%20final.pdf>.

³ Portsmouth Water (2016), 'Portsmouth Water announces partnership with Castle Water to provide retail services to business customers', press release, <https://www.portsmouthwater.co.uk/wp-content/uploads/2016/01/businesses-press-release.pdf>.

⁴ Business Stream (2016), 'Business Stream buys Southern Water's non-domestic customer base', 24 June.

⁵ *Utility Week* (2016), 'Thames Water to exit business retail market'.

⁶ Competition and Markets Authority (2016), 'Anticipated non-household retail water and sewerage services joint venture between Severn Trent Plc and United Utilities Group Plc: Decision on relevant merger situation and substantial lessening of competition', ME/6575/15, 27 May, <https://www.gov.uk/cma-cases/severn-trent-united-utilities-merger-inquiry>, p. 7.

⁷ Previously the UK Competition Commission.

⁸ United Utilities (2016), 'United Utilities and Severn Trent combine non-household retail businesses', 1 March, <http://corporate.unitedutilities.com/4284.aspx>.

⁹ The Business Stream–Southern Water consolidation happened after the JV occurred, and has a lower market share.

¹⁰ Ofwat (2016), 'Water 2020: our regulatory approach for water and wastewater services in England and Wales', 25 May.

¹¹ Competition and Markets Authority (2016), 'Anticipated non-household retail water and sewerage services joint venture between Severn Trent Plc and United Utilities Group Plc: Decision on relevant merger situation and substantial lessening of competition', ME/6575/15, 27 May, <https://www.gov.uk/cma-cases/severn-trent-united-utilities-merger-inquiry>, p. 2.

¹² Ofwat and Water Industry Commission for Scotland (2014), 'Overview of the competitive retail market for water and sewerage services', January, p. 4.

¹³ Although note that there are a number of differences between the Scottish and English markets. For example, there are generally higher margins in Scotland. Scotland also has pre-payment credit terms, whereas Ofwat has proposed to allow market participants to choose from a range of credit options. See Ofwat (2016), 'Credit terms between wholesalers and retailers in the new retail market – a consultation', June, <http://www.ofwat.gov.uk/consultation/credit-terms-wholesalers-retailers-new-retail-market/>, for further details.

¹⁴ Ofwat (2014), 'Setting price controls for 2015-20. Final price control determination notice: policy chapter A5 – household retail costs and revenues', December, http://www.ofwat.gov.uk/wp-content/uploads/2015/10/det_pr20141212hhretail.pdf.

¹⁵ Competition and Markets Authority (2016), 'Energy market investigation – Final report', p. 388.

¹⁶ However, energy hedging is more complicated than the proposed wholesale access arrangements for water, which may suggest a higher minimum efficient scale in energy.

¹⁷ Ofwat (2014), 'Setting price controls for 2015-20. Final price control determination notice: policy chapter A5 – household retail costs and revenues', December, http://www.ofwat.gov.uk/wp-content/uploads/2015/10/det_pr20141212hhretail.pdf, p. 35.

¹⁸ For example, energy company SSE provides water services within an appointed region; see SSE, 'About SSE Water', <https://www.sse.co.uk/help/water/about#item1>. Thames Water and energy supplier, British Gas, are providing joint water and energy efficiency advice; see Thames Water (2012), 'Water and gas firms join forces to combat drought and energy waste', 30 January, <http://www.thameswater.co.uk/media/press-releases/15307.htm>.

¹⁹ UK Parliament (2013), 'Introducing Retail Competition in the Water Sector'.

²⁰ *Utility Week* (2016), 'Chief executive's view: the water market must work for customers', 27 May.