

Agenda

Advancing economics in business

Water company mergers: further developments in the pipeline?

The water industry in England and Wales is unique in being subject to a ‘special merger regime’. Recently the UK government has sought to bring this regime more into line with the general merger regime that applies in other sectors in the UK. Meanwhile, the UK Competition and Markets Authority (CMA) has undertaken an inquiry into the Pennon acquisition of Bournemouth Water. What are the implications of these developments for the scope for water company mergers?

Historically, under the special merger regime, all mergers (where one or both parties had a regulated turnover of over £10m) were automatically referred for a Phase 2 merger inquiry.¹ The rationale was that the incumbent companies had largely naturally monopolistic functions, and therefore Ofwat, the economic regulator of the water industry in England and Wales, used comparisons in setting efficient costs, performance levels and, ultimately, price limits.² During the Phase 2 inquiry, the CMA—and before 2014, its predecessor body, the Competition Commission—would assess whether the merger had a negative impact on Ofwat’s ability to make comparisons across companies in setting price limits. This assessment would be based on Ofwat’s price review methodology and comparative tools prevailing at the time, under the assumption that the methodology would remain largely unchanged in the future.

However, several recent developments have meant that the water merger regime is in a state of change. This article explores these developments and considers their possible implications for future mergers in the industry.

Changes brought about by the Water Act 2014

The purpose of the general merger regime in the UK is to examine whether a merger would be expected to cause a substantial lessening of competition. However, the rationale for the special merger regime in water is somewhat different and relates to the impact of the merger on Ofwat’s comparative regulation regime.

The Water Act 2014 (WA14) has brought about the most fundamental change to the water merger regime since it was introduced in the early 1990s. According to the relevant

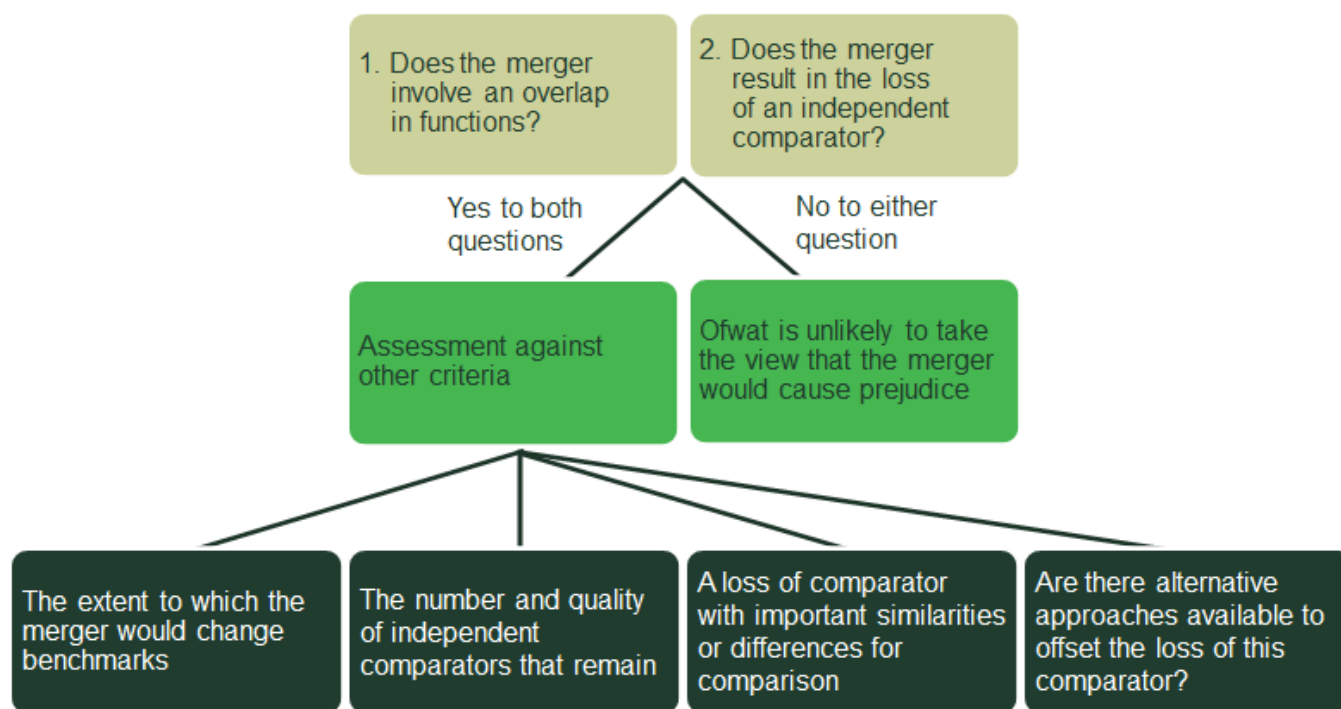
provisions, which came into force on 15 December 2015, the CMA is now able to clear a merger during Phase 1 in lieu of a full Phase 2 inquiry.³ This brings the water merger regime somewhat more into line with the general merger regime in the UK. To reflect this change, the CMA published new guidance on water mergers in November 2015.⁴ The guidance sets out the following conditions under which the CMA would clear a merger during Phase 1:

- the merger is not likely to prejudice Ofwat’s ability, in carrying out its functions under the Water Industry Act 1991, to make comparisons between water companies; or
- the merger is likely to prejudice that ability, but the prejudice is outweighed by relevant customer benefits (RCBs) that are specific to the merger.⁵

As with general mergers in the UK, the WA14 also gives the CMA the power to accept undertakings in lieu of a Phase 2 inquiry in the event that the merger is assessed to have a prejudicial effect on Ofwat’s ability to make comparisons between water companies.⁶ In this case, the undertakings must remedy, mitigate or prevent the prejudicial effect.

In coming to a decision to clear the merger or accept undertakings in lieu of a Phase 2 inquiry, the CMA must request and consider Ofwat’s opinion on whether either of the two conditions above hold.

The WA14 also requires Ofwat to spell out how it will form its opinion on the merger, in the form of a statement of methods.⁷ Figure 1 overleaf provides an overview of how Ofwat would do this.

Figure 1 Ofwat statement of methods and assessment framework

Source: Oxera, based on Ofwat (2015), 'Ofwat's approach to mergers and statement of methods', October, pp. 11–13.

Given the current industry structure, in which water-only companies and water and sewerage companies mainly have overlapping functions, Ofwat is likely to answer 'no' to either of the first two questions in only a limited number of circumstances. One such instance would be if a water-only company were seeking to take over the sewerage functions of an existing water and sewerage company.⁸

In this regard, it would appear that most water mergers would be subject to assessment against the subsequent criteria shown in Figure 1. This would involve Ofwat seeking to monetise the merger impacts as far as possible and comparing the monetised and remaining qualitative impacts against the RCBs that were expected to flow from the merger. The box sets out the criteria for RCBs.

Another observation is that, while the legal process may look somewhat different, the criteria to be examined appear broadly similar to the areas of analysis in previous inquiries. This may mean that one would expect to see the same form and breadth of analysis that have been observed in previous merger inquiries, albeit with a potentially more pre-defined structure.

Lessons from the Pennon acquisition

In April 2015, Pennon Group, the owner of South West Water, acquired Sembcorp Bournemouth Water (SBW).⁹ Although the new merger regime was not in place in time for this development, the acquisition was interesting for several other reasons, including being the first merger following Ofwat's methodology for PR14.¹⁰

First, Ofwat and the CMA examined the impact of the merger on each of the overlapping price controls—the

wholesale water price control and the household retail price control. Figure 2 overleaf provides an overview of the CMA's approach, the areas examined, and the CMA's final assessment in each area.

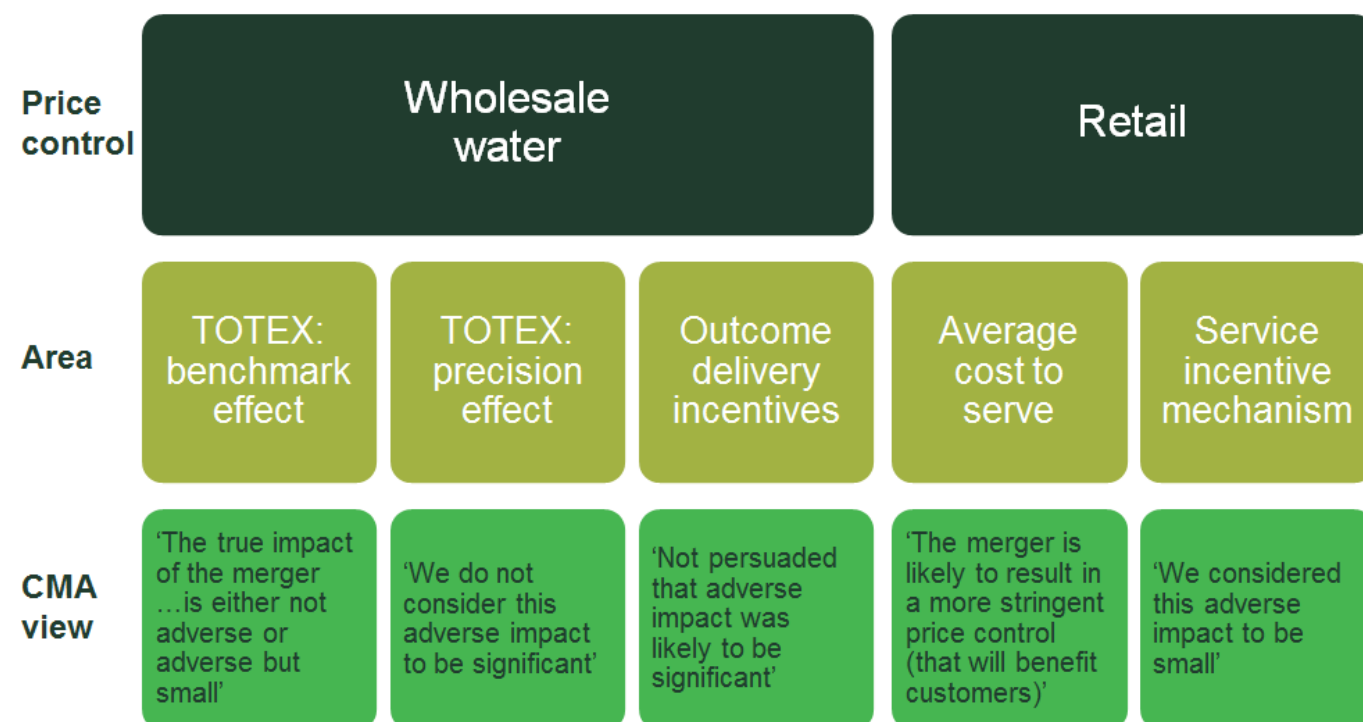
Second, in coming to its assessment, the CMA used both a 'static' and a 'forward-looking' approach.¹¹ The 'static' approach considered the impact of the merger using the regulatory framework that Ofwat used in PR14 and, where appropriate, the relative performance rankings of SWW and SBW (e.g. where they ranked on cost efficiency or levels of service compared with other water companies) to provide a

Ofwat's criteria for relevant customer benefits

- Are there relevant customer benefits? These must be in terms of lower prices, higher quality or greater choice of services or greater innovation in relation to such services and must accrue to customers of merger parties.
- How likely or certain are the benefits to be achieved?
- Are the benefits merger specific? The benefits must be a direct result of the merger (and unlikely to occur otherwise).
- Are benefits likely to accrue in a reasonable period of time?
- Are benefits likely to be sustained?

Source: Ofwat (2015), 'Ofwat's approach to mergers and statement of methods', October, p. 14.

Figure 2 Overview of the CMA's approach and assessment



Source: Oxera, based on Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment', November, pp. 8, 9, 10, 12 and 13.

new ranking for the combined entity. The 'forward-looking' approach considered how SWW, SBW and the merged entity might perform in future price reviews, which included a consideration of their possible future efficiency rankings and changes to Ofwat's methodology (e.g. if Ofwat decided to move from an upper-quartile to a frontier efficiency challenge).¹² In this regard, when measuring the impact of the merger over the standard 25-year assessment period, the inquiry did not consider the impact on future non-household retail price controls. This is because the introduction of competition in this area is expected to remove the need for comparative regulation in the future.

Third, while Ofwat did not oppose the merger, it did assess that it would have a detrimental impact on the regulator's ability to make comparisons, and therefore sought for remedies to be applied.¹³ However, the CMA concluded that this was not likely. Experience from the Pennon acquisition therefore shows that the regulators are capable of reaching different conclusions.

So what next for water company mergers?

Arguably, the greatest challenge in a merger inquiry is how to measure the merger's effect some 25 years into the future. This is especially pertinent now that the water industry is in its greatest period of change since privatisation in 1989. Relevant considerations include:

- the introduction of non-household retail competition in 2017;

- the introduction of upstream markets beyond 2019, in the shape of a competitive market for water resources and sludge;¹⁴
- the future form of the household retail price control, and the government's consideration of whether to extend retail competition to households;¹⁵
- changes to Ofwat's regulation of naturally monopolistic activities, and their implications for the TOTEX econometric models and outcome delivery incentives.¹⁶

In this regard, the CMA guidance is careful not to tie itself to one particular approach.¹⁷ Indeed, the CMA has noted that 'The guidance also recognises that the CMA's approach may change to reflect any future developments in Ofwat's approach to regulation, and how it uses comparators.' Further, it notes that it had removed a paragraph from its draft guidance in order to give itself more flexibility to adjust its approach in response to future developments. This is with regard to the weight placed on the static and forward-looking analysis.¹⁸

Another important factor is the extent to which Ofwat views water company mergers positively—especially now that it will provide an opinion during Phase 1. Ofwat has made a number of statements regarding the scope for future mergers in the sector, recognising the importance of an effective market for corporate control and saying that it was 'open to these conversations' about structural changes.¹⁹ In addition, Ofwat has said that if it is able to make more use of market testing and comparators from beyond the sector, it will be

less reliant on intra-industry comparators than it has been in the past.²⁰ Such a move would be expected to have positive implications for merger approval in the sector.

In addition, in March 2015 Ofwat's chairman, Jonson Cox, challenged the industry to think about different ideas for mergers:²¹

We're interested in different ideas. So think about this. Why do water companies need to be water and waste water companies? They're generally run as two completely separate services. Would there be more efficiencies available by two companies putting their water businesses together, and by putting their waste water businesses together, in two separate entities? A merger of this form might indeed be simpler under the process for merger referrals. What would we gain in benefits to customers if two companies put their wholesale businesses together in one corporate entity and then under separate ownership, their two retail businesses together? It feels like there's more economies of scale to us in the retail than in the networks, but we look forward to seeing what people have to say.

As the other reforms introduced through the WA14 start to take hold (such as non-household retail competition and non-household 'retail exit'²²), some companies may seek opportunities to create value and rise to the regulator's

challenge by proposing different types of merger. These in themselves may throw up issues that are different from those considered in previous merger inquiries. For example, they might concern:

- market definition;
- the combined market share of the merged entity;
- whether such mergers (particularly those between companies' contestable functions) would better fall under the general merger process, rather than be subject to Ofwat's stated methodology, which is explicitly designed to assess detriment to its comparative framework.

Conclusion

The special merger regime in water clearly has an important role to play in the regulation of the sector—the market for corporate control provides the opportunity to create value for investors and deliver further efficiencies to the benefit of water customers. The recent changes to the merger regime provide a significant opportunity to improve the merger process, including the possibility of clearance at Phase 1. Changes to the regulation of the industry, which are likely to provide opportunities for further consolidation, mean that the merger control regime is likely to have an even more important role in the future.

¹ See section 33 of the Water Industry Act 1991, http://www.legislation.gov.uk/ukpga/1991/56/pdfs/ukpga_19910056_en.pdf. Phase 1 is a 40-day process that comprises the CMA's preliminary examination of the merger. The CMA makes one of the following decisions at the end of Phase 1: unconditional clearance; clearance subject to legally binding undertakings; or a reference for a Phase 2 investigation. Phase 2 is a full investigation by the CMA, which has a longer timescale and involves written submissions and oral hearings. See Practical Law (2015), 'Merger control in the UK (England and Wales): overview', <http://uk.practicallaw.com/0-500-7317#a918988>.

² For further background on the special merger regime in water, see, for example, Oxera (2012), 'The case of South Staffordshire/Cambridge: is clearer water emerging?', *Agenda*, August, <http://www.oxera.com/Latest-Thinking/Agenda/2012/The-case-of-South-Staffordshire-Cambridge-is-clearer-water-emerging.aspx>; and Oxera (2009), 'Water competition: a clear way forward?', *Agenda*, June, <http://www.oxera.com/Latest-Thinking/Agenda/2009/Water-competition-a-clear-way-forward.aspx>.

³ UK government, 'Water Industry, England and Wales: the Water Act 2014 (Commencement No.5 and Transitional Provisions) Order 2015', http://www.legislation.gov.uk/uksi/2015/1938/pdfs/uksi_20151938_en.pdf.

⁴ Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment', November.

⁵ Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment', November, p. 6.

⁶ Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment', November, p. 6.

⁷ Ofwat (2015), 'Ofwat's approach to mergers and statement of methods', October.

⁸ Ofwat (2015), 'Ofwat's approach to mergers and statement of methods', October, p. 12.

⁹ Pennon Group Plc (2015), 'Bournemouth Water Acquisition', April, <http://www.pennon-group.co.uk/investor-information/bournemouth-water-acquisition>. Oxera was Pennon's lead economic adviser in the merger.

¹⁰ An overview of Ofwat's methodology is provided in Oxera (2013), 'Ofwat's final methodology: now for implementation', *Agenda*, August, <http://www.oxera.com/Latest-Thinking/Agenda/2013/Ofwat%E2%80%99s-final-methodology-now-for-implementation.aspx>.

¹¹ The CMA did not consider the 'static' approach for the household retail benchmark.

¹² Among other things, assessing the monetary impact of the merger would be expected to involve examining its effect on the cost-efficiency benchmark—i.e. whether the merger would be expected to increase or reduce the industry cost-efficiency challenge. The size of the impact would therefore depend on whether the cost-efficiency benchmark were set at the industry upper quartile or the frontier level (i.e. that of the best-performing company).

¹³ Ofwat (2015), 'Ofwat's initial submission to the Competition and Markets Authority following the acquisition of Bournemouth Water Investments Limited by Pennon Group plc', pp. 3–5.

¹⁴ Ofwat (2015), 'Water 2020: Regulatory framework for wholesale markets and the 2019 price review – Explanatory document', December.

¹⁵ HM Treasury (2015), 'A better deal: boosting competition to bring down bills for families and firms', November.

¹⁶ 'Outcomes' are defined as the higher-level objectives that customers and society really value, such as good-quality water that is safe to drink. Outcome delivery incentives seek to attach incentives to these outcomes through providing reputational and financial rewards and penalties based on operational service.

¹⁷ Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment', November.

¹⁸ Competition and Markets Authority (2015), 'Water and sewerage mergers: guidance on the CMA's procedure and assessment. Summary of responses to the consultation', November, p. 7.

¹⁹ Beech, M. (2014), 'Ofwat "opening the door" to mergers', *Utility Week*, 4 April, <http://utilityweek.co.uk/news/ofwat-%E2%80%99opening-the-door%E2%80%99-to-mergers/995732#.VklVWLfhBpg>; Ross, C. (2015), 'Sector challenges and Water 2020', Ofwat, 15 October, http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_pre20151015challenges.pdf.

²⁰ Ross, C. (2015), 'Sector challenges and Water 2020', Ofwat, 15 October, p. 10, http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_pre20151015challenges.pdf.

²¹ Cox, J. (2015), 'Unchartered Waters: a Forward Look at Managing Change in the Water Sector', Speech to Policy Exchange, 11 March, <http://policyexchange.org.uk/modevents/item/unchartered-waters-a-forward-look-at-managing-change-in-the-water-sector>.

²² The process through which an incumbent water company can divest its non-household retail activities, including to a company within the same parent company group. Department for Environment, Food & Rural Affairs, 'Retail exits reform: how we plan to implement new regulations', <https://consult.defra.gov.uk/water/retail-exits-reform>.