| | |
|---|---|
| **Title:**<br>Reform of the Water Special Merger Regime<br>**IA No:** Defra 1435<br>**Lead department or agency:**<br>Defra<br>**Other departments or agencies:**<br>Ofwat, Office of Fair Trading, Competition Commission | **Impact Assessment (IA)**<br>**Date:** 02/07/12<br>**Stage:** Final<br>**Source of intervention:** Domestic<br>**Type of measure:** Primary legislation<br>**Contact for enquiries**:<br>Nick Jenkins<br>nick.jenkins@defra.gsi.gov.uk |

## Summary: Intervention and Options

**RPC Opinion:** AMBER

| Cost of Preferred (or more likely) Option | | | | |
|---|---|---|---|---|
| **Total Net Present Value** | **Business Net Present Value** | **Net cost to business per year** (EANCB on 2009 prices) | **In scope of One-In, One-Out?** | **Measure qualifies as** |
| N/A | N/A | N/A | No | NA |

What is the problem under consideration? Why is government intervention necessary? The current special merger regime for the water industry is not sufficiently transparent because the methodology that Ofwat use in assessing the impact of a merger on their capacity to undertake comparative regulation is not in the public domain. This causes uncertainty for water companies and imposes costs that could be avoided if greater clarity were available. In addition, the Office of Fair Trading (OFT) is obliged to refer all water mergers to the Competition Commission (CC), without the option to accept undertakings from the merging parties to remedy or mitigate any prejudicial effects of a merger (as is the case in the general merger regime). The Cave review recognised that this has a “chilling” effect on potentially beneficial water company mergers. Deregulatory intervention is required to remove these barriers by filling the information gap and increasing flexibility in the regime

**What are the policy objectives and the intended effects?**

The policy objective is de-regulatory and is designed to provide greater clarity to water companies that wish to merge. The aim is to create closer alignment with the general merger regime whilst retaining Ofwat's capacity for comparative competition. The proposed changes aim to remove some of the barriers to water companies taking forward mergers, in response to recommendations in the Cave Review. They will improve the capacity of water companies to take more informed decisions on the likely outcome of a merger reference, allowing them to offer undertakings in lieu of a reference to the CC and to avoid the costs of an expensive referral if the prospects of success are considered to be low.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

Base case – Do nothing
Option 1 - require Ofwat to publish guidance on how it would assess the loss of a comparator ;
Option 2 - require Ofwat to publish guidance on how it would assess the loss of a comparator; and the introduction of a first stage merger test by the OFT (informed by the Ofwat guidance) and the introduction of powers whereby OFT can accept undertakings from water companies in lieu of a reference to the CC.

Option 2 is preferred on the grounds that it introduces greater clarity around the way in which the loss of a comparator will be valued and it potentially reduces the burdens and costs on water companies during a merger.

**Will the policy be reviewed?** It will be reviewed. **If applicable, set review date:** Ongoing

| | | | | | |
|---|---|---|---|---|---|
| Does implementation go beyond minimum EU requirements? | | | N/A | | |
| Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base. | **Micro**<br>No | **< 20**<br>Yes | **Small**<br>Yes | **Medium**<br>Yes | **Large**<br>Yes |
| What is the $CO_2$ equivalent change in greenhouse gas emissions?<br>(Million tonnes $CO_2$ equivalent) | | | **Traded:**<br>N/A | **Non-traded:**<br>N/A | |

***I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.***

***Signed by the responsible SELECT SIGNATORY:*** Richard Benyon ***Date:*** 9 June 2013

# Summary: Analysis & Evidence

Policy Option 1

**Description:** Ofwat to produce guidance on how it would assess the loss of a comparator

**FULL ECONOMIC ASSESSMENT**

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | **Low:** N/A | **High: N/A** | **Best Estimate: N/A** |

| **COSTS (£m)** | **Total Transition** (Constant Price) | Years | **Average Annual** (excl. Transition) (Constant Price) | **Total Cost** (Present Value) |
|---|---|---|---|---|
| **Low** | N/A | | N/A | **N/A** |
| **High** | N/A | | N/A | **N/A** |
| **Best Estimate** | Negligible | | Negligible | **Negligible** |

**Description and scale of key monetised costs by 'main affected groups'**

There are no monetised costs associated with this option. Indicative, illustrative costs based on information from the OFT are set out in the body of the IA

**Other key non-monetised costs by 'main affected groups'**

Ofwat have confirmed that the requirement to publish guidance on how it would assess the loss of a comparator (and keep it under review) is expected to have negligible cost implications for them. This is because much of the information already exists (due to work undertaken in relation to previous merger referrals) and it merely requires collating into an appropriate framework for guidance, making clear the approach OfWAT takes anyway.

| **BENEFITS (£m)** | **Total Transition** (Constant Price) | Years | **Average Annual** (excl. Transition) (Constant Price) | **Total Benefit** (Present Value) |
|---|---|---|---|---|
| **Low** | N/A | | N/A | **N/A** |
| **High** | N/A | | N/A | **N/A** |
| **Best Estimate** | | | | |

**Description and scale of key monetised benefits by 'main affected groups'**

It has not been possible to monetise the benefits for this option. There are two main reasons for this. Firstly, the benefits are indirect. In addition, it is not possible to forecast the number or combination of any future mergers. The water industry is very diverse in terms of the size, turnover and performance of the 21 companies within it.

**Other key non-monetised benefits by 'main affected groups'**

- Increased transparency and the removal of the uncertainty associated with a future merger reference (because there will be greater understanding about how Ofwat will value the loss of a comparator). Water Companies will therefore be able to assess with a degree of confidence exactly how Ofwat will view the loss of a comparator
- As a consequence a potential indirect benefit could be cost savings from avoiding a fruitless merger reference.

Key assumptions/sensitivities/risks **Discount rate (%)**

A key assumption is that there are water companies considering merger activity.

**BUSINESS ASSESSMENT (Option 1)**

| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
|---|---|---|---|---|
| **Costs:** N/A | **Benefits:** N/A | **Net:** N/A | Yes | Zero net cost |

# Summary: Analysis & Evidence

Policy Option 2

**Description:** Ofwat guidance and introduction of OFT 1st stage test with power to accept undertakings in lieu of reference to CC.

**FULL ECONOMIC ASSESSMENT**

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | **Low:** N/A | **High:** N/A | **Best Estimate: N/A** |

| **COSTS (£m)** | **Total Transition** (Constant Price) | Years | **Average Annual** (excl. Transition) (Constant Price) | **Total Cost** (Present Value) |
|---|---|---|---|---|
| **Low** | N/A | | N/A | **N/A** |
| **High** | N/A | | N/A | **N/A** |
| **Best Estimate** | Negligible | | Negligible | **Negligible** |

**Description and scale of key monetised costs by 'main affected groups'** It has not been possible to monetise the costs for this option. There are two main reasons for this. Firstly, the costs are indirect. In addition, it is not possible to forecast the number or combination of any future mergers. The water industry is very diverse in terms of the size, turnover and performance of the 21 companies within it. In addition, we cannot predict which merger cases or how many might be referred onto the CC in the event that undertakings from the merging parties are deemed insufficient to remedy or mitigate any prejudicial effects of a merger.

**Other key non-monetised costs by 'main affected groups'**

Ofwat expect publication of guidance costs to be negligible.

If a company chooses to merge the 1st stage test will not introduce additional costs compared to the baseline case as they are costs that a water company would have incurred had the proposed merger been referred to the CC in the first instance.

Merger assessment costs would only increase if the OFT considered that proposed remedies offered by the merging parties were insufficient to mitigate against the loss of a comparator and referred the merger to the CC – though we would expect analysis at the OFT stage not to have to be repeated, yielding savings at the CC stage and hence balancing out. Anyhow, in such cases the merging parties could withdraw from the merger reference as they would be better informed about the chances of ultimate success.

| **BENEFITS (£m)** | **Total Transition** (Constant Price) | Years | **Average Annual** (excl. Transition) (Constant Price) | **Total Benefit** (Present Value) |
|---|---|---|---|---|
| **Low** | N/A | | N/A | **N/A** |
| **High** | N/A | | N/A | **N/A** |
| **Best Estimate** | | | | |

**Description and scale of key monetised benefits by 'main affected groups'**

It has not been possible to monetise the benefits for this option. This is primarily because the key benefits of greater transparency and certainty are qualitative. The indirect benefits are not amenable to monetisation as there is no evidence available to inform assumptions on which water companies, and how many intend to merge. There is also a high level of complex variation in the merger reference itself and amongst the 21 water companies which further significantly restricts the scope. It is impossible to predict in advance of a reference whether undertakings offered by the merging parties are likely to be deemed sufficient to remedy or mitigate any prejudicial effects of a merger.

**Other key non-monetised benefits by 'main affected groups'**

- Greater transparency and give water companies more certainty over the way in which future mergers will be considered.
- Removal of this uncertainty may potentially lead to increased merger activity, though the threshold for referral of mergers to OFT will remain the same so the general level of scrutiny will be streamlined rather than loosened. (Potential changes to thresholds for OFT scrutiny are being considered separately).
- Giving the OFT power to accept undertakings in lieu of a full referral to the CC could potentially reduce the time and costs of a merger reference.
- Additional indirect benefits through increased merger activity could include: Greater capital market competition, Economies of scale; and, for neighbouring companies, greater optimisation of water resources

Key assumptions/sensitivities/risks | **Discount rate (%)** |

A key assumption is that there are water companies considering merger activity and who will derive the benefits stated.

**BUSINESS ASSESSMENT (Option 2)**

| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
|---|---|---|---|---|
| **Costs:** N/A | **Benefits:** N/A | **Net:** N/A | Yes | **Zero net cost** |

# Evidence Base (for summary sheets)

This Impact Assessment comprises of two complementary reforms to the water special merger regime that are designed to make the regime more transparent and reduce costs for water companies through the avoidance of a costly referral to the CC.

The IA is structured as follows:

Section 1 provides an overview of the relevant background and context for the IA

Section 2 summarises the base case and the proposed reforms

Section 3 examines the costs and benefits for each of the options

Section 4 Conclusions and One in One Out

## Section 1 – Background and Context

1. In February 2008, the Government commissioned the 'Independent Review of Competition and Innovation in Water Markets[1]' to assess the potential to increase efficiencies in water and wastewater markets, with the aim of lowering prices, improving customer service and delivering environmental benefits. The Review was led by Professor Martin Cave and published its Interim Report in November 2008 and its final report in April 2009. The Review made a large number of recommendations but those that are relevant to this impact assessment are:

1) Ofwat to publish guidance on comparator methodology. Give Ofwat a statutory duty to develop and publish guidance on its approach to assessing the loss of a comparator after consultation with stakeholders. This should set out the criteria, weightings and methodology used in any future assessment.

2) A first stage merger test. Based on its published guidance, Ofwat should provide specific advice on a merger to the OFT, including an assessment of the scale of any prejudice. The OFT should consider that advice, as well as any other competition effects arising from the merger and the scope for structural or behavioural remedies (if offered by the parties), when considering the need for referral to the CC.

3) The Government to review success of regime after five years.

### The current framework for mergers in the water industry

2. The water industry has been subject to a special merger regime since the early 1990s. Since 2004 there has also been a reference test under which the OFT must refer to the CC any merger of two or more water undertakings where both of the merging undertakers has a turnover of at least £10 million. This is on the basis that the merger could have a detrimental impact on Ofwat's ability to regulate water industry prices on the basis of comparative competition. There is currently no scope for the OFT to accept undertakings in lieu of a reference to the CC reference in the case of water mergers.

3. In the absence of competition, Ofwat has developed a system of comparative regulation to drive efficiency. The purpose of this regime is to replicate the effects of a competitive market by incentivising each company to improve efficiency and customer service. This is achieved by comparing each company's relative performance and identifying the most efficient water company (known as the frontier company) for a number of costs areas.[2] Ofwat then sets each company a number of targets based on the position of the company relative to the frontier company and also based on expected improvements in the sector (i.e. the frontier also shifts outwards).

4. The CC is required to determine whether such a merger may be expected to prejudice the ability of Ofwat to make comparisons between different water companies for the purpose of regulating them. If the CC determines that a merger does prejudice Ofwat's ability to make comparisons, then it may impose remedies or take no action. The remedies that the CC can impose may be structural (for example divestment) or behavioural (for example reimbursing consumers harmed as a consequence of Ofwat's inability to regulate water companies as effectively).

5. This special merger regime operates in parallel with the normal merger regime under which the OFT has a duty to refer a merger to the CC for further investigation if it believes that there is a realistic prospect that the merger gives rise to a substantial lessening of competition within any market or markets for goods or services in the UK. The OFT is not empowered to examine all mergers. To qualify for examination by the OFT under the normal merger regime:

- the UK turnover of the acquired company, which need not be the smaller of the merger firms, must exceed £70 million a year or;

[1] Independent Review of Competition and Innovation in Water Markets
http://www.defra.gov.uk/environment/water/industry/cavereview/

[2] In particular, Ofwat compares water undertakers' estimates of the cost of performing a number of standardised capital works (such as laying lengths of different diameters of water pipes in different types of ground) to help decide which company is the most efficient.

- the combined entity must have at least a 25 per cent share of supply of any description of goods or services in the UK or a substantial part of the UK(where the merger has given rise in an increment in that share of supply).

6. Even in situations where the OFT finds that a merger does give rise to a realistic prospect of a substantial lessening of competition, the OFT may nonetheless choose to exercise its discretion not to make a reference to the CC in the following circumstances:

- if it believes that the market or markets concerned are not of sufficient importance to justify a reference;
- if it accepts undertakings proposed by the merger parties in lieu of reference (such as divestments); or
- if there are relevant customer benefits from the merger that outweigh the substantial lessening of competition.

**Problem to be addressed – the Case for change**

7. Water Companies have very little clarity regarding the methodology that Ofwat would adopt in a merger reference to the CC. This is because Ofwat does not currently publish and make available to water companies the methodology that they would use in assessing the value of a loss of a comparator in a merger reference. Consequently water companies are somewhat in the dark as regards the success or failure of a merger reference.

8. Combined with this, the OFT does not currently have powers to accept in lieu of a CC referral, any undertakings from the acquiring water company to compensate for the loss of a comparator. This means that all proposed mergers between water companies have to be referred to the CC. This automatic reference and potentially some of the costs could be avoided if the reforms set out under Option 2 (page 8) were taken forward.

9. The Cave Review considered that this lack of clarity has led to a "chilling" effect on merger and acquisition activity in the sector as companies have been unable to properly assess ex-ante the likely outcome of such an assessment. As a result potentially beneficial mergers in the sector have been discouraged.

**Consultation on proposed reform of the special merger regime**

10. In September 2009 Defra and the Welsh Assembly Government undertook a public consultation on the Cave Review recommendations[3]. The consultation sought views from stakeholders and the general public on competition in the water and sewerage sector as well as the specific recommendations of the Review. In total 53 responses were received.

11. The key question and responses in relation to the special merger regime and the subject of this IA are summarised below:

| |
|---|
| **Do you agree to the Government's suggested approach to the first phase referral of water mergers to the OFT and that the OFT should been given powers to accept undertakings in lieu of reference of water mergers to the CC?** |

12. In response to the above question 17 respondents, including Ofwat, CCWater and 12 water companies supported the introduction of a first phase referral and that the OFT should be given powers to accept undertakings in lieu of a reference to the CC. The response from Ofwat stated:

> "We support the suggested approach, which we recommended in our response to the interim report of the Cave review. This is a flexible approach in which the OFT, on the basis of our advice, has the opportunity to refer a merger to the CC. We and the OFT can consider the impact

[3] Defra, A summary of responses to the consultation on the Cave Review of competition and innovation in water markets, August 2011, http://www.defra.gov.uk/environment/quality/water/industry/

[4] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/south-staff-cambridge-water/severn_trent_water_initial_submission.pdf

of the proposed merger and any measures to balance the potential dis-benefits to customers. Flexibility means that ongoing market developments and potential changes in price regulation could be incorporated in any assessment. The reforms could also reduce the procedural costs to companies and improve the speed of decisions."

13. The remaining respondents to the consultation either did not provide an answer to the question or did not express a particular view either way.

14. More recently, Severn Trent Water in providing a response to the CC in respect of the merger reference between South Staffordshire Water and Cambridge Water said: "*We consider that merger restrictions in mergers in the water industry have disadvantaged customers. We support the conclusions of the Independent Review of Competition and Innovation in Water Markets, carried out by Professor Martin Cave for Defra, that: 'The special merger regime represents a significant barrier to further consolidation, adversely affecting the scope for efficiency gains, financing costs and resource optimisation'. Reduced restrictions on mergers would increase pressure on company managements to reduce costs, as companies that were inefficient would face greater threat of being taken over. It would also enable economies of scale to be achieved".*[4]

## Section 2 - Proposed reforms

### Option 1 Introduction of a duty for Ofwat to publish guidance on its approach to assessing the loss of a comparator

15. The Cave Review recommended that Ofwat publish the criteria, weightings and methodology it would apply in valuing the loss of a comparator in a merger referral (for example, that used by the CC in the Mid Kent Water and South East Water merger) and to develop such an approach in conjunction with other stakeholders in order to remove uncertainty over the way in which mergers will be considered.

16. Currently, under the special water merger regime, when a merger is proposed Ofwat submits evidence to the CC on the impact of a loss of a comparator, as do the merging parties and other stakeholders. This is then considered by the CC in forming a judgement as to whether the merger prejudices Ofwat's system of regulation by comparative competition. The criteria, weightings and methodology used by Ofwat in the assessment that it submits to the CC are not transparent, resulting in considerable uncertainty for merging parties. This is clearly demonstrated in Mid Kent Water/South East Water merger case where there were significant differences in the estimates by Ofwat and CC on the value of the loss of a comparator - Ofwat's estimate was £200 million over 30 years but the CC concluded that the estimate was £9 million[5].

17. Even if the jurisdictional threshold for water mergers was raised from £10m at a later date (being considered separately), this uncertainty over Ofwat's valuation would remain.

### Option 2 Introduction of a duty for Ofwat to publish guidance on its approach to assessing the loss of a comparator; and Introduction of a new first stage test - removal of automatic requirement for OFT to refer all mergers over the threshold to the CC and Ofwat to provide advice on merger detriment to the OFT

18. For merger proposals where both companies have a turnover in excess of £10m, in place of an automatic reference to the CC it is proposed there would be a stage one assessment by the OFT. This assessment would need to include a prejudice test whereby Ofwat provide the OFT with an initial assessment of the expected impact of the loss of a comparator. Based upon that assessment the merging parties could then propose remedies/undertakings to the OFT in order to offset the loss of a comparator. The OFT will consider the suitability of the remedies/undertakings taking account of advice received from Ofwat on the comparative assessment and taking account of any views provided by Ofwat

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[5] Competition Commission, 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, 2007. http://www.competition-commission.org.uk/rep_pub/reports/2007/fulltext/525.pdf

on the suitability of the remedies. Ofwat may give a view on the potential acceptability of remedies and the evaluation should be informed by Ofwat's published assessment of the value of a comparator.

19. If the OFT consider that the undertakings/remedies proposed are not sufficient to mitigate against the loss of a comparator the proposed merger would then be referred to the CC who would look at it in the same way it does under the existing special merger regime. However, at this stage water companies subject to the proposed merger could decide to abandon the merger (only if the OFT considered that a merger had not already taken place). For instance they may conclude that the CC is likely to consider that the benefits of the merger are outweighed by the loss of a comparator. Withdrawal from a merger reference at this stage will save a water company the costs of a full referral to the CC.

## Section 3 - Costs and benefits

### Monetisation of Costs and Benefits

20. In assessing the impact of the proposed reforms we have not attempted to quantify the costs and benefits in an absolute sense. This is primarily because these reforms do not create a certain outcome in terms of the industry structure that would emerge. In particular, we cannot know which companies would choose to merge or acquire which other companies, and any quantitative analysis of the outcome of these reforms would effectively require us to predict that outcome. These reforms simply remove an artificial barrier to mergers by reducing the scope of the current SMR. This would reduce the uncertainty associated with a referral under that regime and any resulting chilling effect. We can assume that more mergers might take place but not how they will take place and between whom.

21. The costs provided within the are IA are indicative and reflect the diverse nature of water and sewerage companies in England and Wales. There are extreme and marked variations not just between the turnover (see table below) of the companies but also the services that they provide and the way in which they operate. For instance, some water companies undertake retail services in house whilst some outsource this function. This means that in order to accurately predict the costs and benefits not only would we need to know which companies are considering are merger (the larger the companies the more the costs) but also the complexity of the merger reference. A merger between two water only companies with an annual turnover of £25m will be less complex and time consuming than a merger between two water and sewerage companies with an annual turnover in excess of £1,500m. In addition, costs to water companies will depend to a great extent on the resources and effort (consultancy costs, management time) dedicated to getting a reference cleared.

Turnover by Company (Source Ofwat)

| Water and Sewerage companies | | Water only companies | |
|---|---|---|---|
| | Turnover £m | | Turnover £m |
| Thames Water | 1,600.0 | Veolia Water Central | 241.3 |
| United Utilities | 1,506.6 | South East Water | 184.7 |
| Severn Trent Water | 1,372.1 | Bristol Water | 97.5 |
| Anglian Water | 1,079.3 | South Staffs Water | 84.5 |
| Yorkshire Water | 859.7 | Sutton & East Surrey | 53.1 |
| Dwr Cymru (Welsh) | 668.9 | Sembcorp Bournemouth Water | 40.4 |
| Northumbrian Water | 655.2 | Portsmouth Water | 35.5 |
| Southern Water | 642.1 | Dee Valley Water | 21.3 |
| South West Water | 444.3 | Cambridge Water | 20.2 |
| Wessex Water | 440.3 | Veolia Water Southeast | 18.3 |
| | | Veolia Water East | 14.4 |

Veolia Central, Veolia South East and Veolia Water East are under common ownership.

22. As regards costs on the Regulator, Ofwat have confirmed that the introduction of a statutory duty to publish an approach to evaluating the loss of a comparator is not expected to lead to significant cost implications. Any merger event would require them to evaluate the effect of the loss of a comparator and it is expected that collating and updating their policies in this area would be part of their normal business outputs. The additional burden would relate to publication its approach to evaluation of the loss of a comparator.

**The base case**

23.. The base case envisages no changes to the existing special mergers regime. Therefore, the OFT must refer any merger between appointed water companies to the CC except in cases where the annual turnover of one of the companies is less than £10m. This would be the case even if one or both water companies were not subject to Ofwat's comparative regulation regime (e.g. mergers between or with inset appointees).[6]

24. As a result the burden of an automatic referral to the CC will continue as will the uncertainty for water companies on how to evaluate the costs of a potential merger.

**Benefits**

25. The primary benefit of the special mergers regime is that it supports Ofwat's approach to regulation. Specifically the regime ensures that there are enough comparators to make statistically robust comparisons of each company. In the absence of sufficient comparators Ofwat's ability to challenge the performance of companies could be weakened. However mergers may still go ahead even if Ofwat believes that there would be an impact on its ability to make comparators. This is demonstrated in the Mid Kent/South East merger where the CC allowed the merger despite the adverse effect on Ofwat's ability to make comparisons between water enterprises.

**Costs**

26. Although the special merger regime does not prohibit mergers between water companies, the lack of clarity surrounding the valuation of a comparator and the inability of the OFT to accept undertakings or remedies to offset the loss of a comparator can result in a disincentive for companies to merge.

27. The lack of guidance and a transparent methodology over assessing the value of the loss of a comparator results in significant uncertainties associated with a reference to the CC. This means that companies are unable to effectively assess the risks associated with a prospective merger and can lead to water companies incurring the unnecessary costs of an expensive referral to the CC. The Cave review found that this by itself deterred mergers regardless of the costs and benefits to the business and ultimately the customers of those businesses.

28. Besides the uncertainty caused by the special merger regime, there are also considerable legal, consultancy and management costs that any company considering a merger may be expected to incur as a result of a reference to the CC. Typically these costs per merger may range between £500,000 and £2 million.[7] However, these costs are determined by the size of the companies involved in a merger which, going forward, we can't know and which precludes an aggregate cost assessment.

29. Correspondingly, the benefits gained from Ofwat's comparative regulation regime and those that we can expect that regime to deliver in the future are maintained and continue. Although recently Ofwat has recognised in its consultation on Future Price Limits that at an industry level, both operating expenditure and capital expenditure outperformance have reduced over time and in time and in the most recent price review period has delivered a 1.6% industry wide operating cost efficiency improvement. This suggests that the effectiveness of the existing comparative efficiency approach may be diminishing. But it could take a number of years to implement any changes to comparative regulation and for Ofwat to collect sufficiently robust alternative data sets that could replace comparators.

[6] A process of appointing a new undertaker to serve customers where these customers are either currently unserved (e.g. new developments), qualify as large users (meaning they would have forecast water demand of more than 50Ml in England and 250Ml in Wales) and wish to change their water and sewerage supplier or where two undertakers agree to change the supply to that site.

[7] Arnold & Parker (2006) UK Competition Policy & Shareholder value: the impact of merger inquiries.

### Option 1

### Introduction of a duty for Ofwat to publish guidance on its approach to assessing the loss of a comparator

30. Ofwat would be required to publish guidance and keep under review on how it would assess the loss of a comparator. The guidance should set out the criteria to be used for assessing the effect of a merger and how a prospective merger might affect its ability to make comparisons between water companies (i.e. methodology, criteria, weightings etc). Ofwat will be required to consult various stakeholders including the OFT, the CC and water and sewerage companies before publishing or updating its guidance. This guidance will be used to inform water companies, the OFT and the CC about the potential cost of mergers as regards comparators and may include details and guidance on the types of undertakings/remedies that might be required to offset the loss of a comparator.

### Benefits

31. The primary benefit of this reform is that it would make it easier for water companies and other stakeholders to evaluate the costs (both financial and administrative) of a potential merger and give them greater clarity of how Ofwat would value the loss of a comparator. Under the current arrangements companies and stakeholders have a limited sight of the methodology and weightings that Ofwat will adopt in valuing a comparator aside from reviewing published information on previous mergers (the last merger reference to the CC was Mid Kent/South East Water in 2007 and in that case the difference in the valuation of the loss of a comparator was significant – see paragraph 14). As a result companies are unable to make an informed decision about how Ofwat are likely to view a potential merger and whether the merger is likely to be cost-beneficial in the wider sense (i.e. not just to the companies involved but to the sector).

32. Requiring Ofwat to publish guidance on its approach to evaluating the loss of a comparator (rather than responding to a proposed merger with a bespoke approach) is an important part of providing the industry with increased certainty. A transparent assessment methodology would provide merging parties with much greater certainty about the criteria weighting and methodology that Ofwat would use in evidence it submits to the CC (and OFT).

33. If this guidance was made available to water companies they would have a much clearer understanding of the way in which Ofwat values comparators and would be able to use the information to inform decisions regarding the likely scale and nature of any undertaking (remedies) required to offset the loss of a comparator. They would be able to make much more informed decisions on whether to proceed with a merger and could weigh up the benefits in terms of efficiency savings against the potential costs of the loss of a comparator which would be reflected in compensation to consumers. For instance, they could weigh up the benefits in terms of efficiency savings, interconnecting of networks against the potential costs of a loss of a comparator which would be reflected in compensation to consumers. And by working with stakeholders Ofwat would be able to benefit from the experience of others and there would be a shared understanding of the approach adopted.

34. Publication of the guidance and a clear assessment methodology will also introduce greater certainty for water companies in the manner in which the CC would consider the loss of a comparator should a merger reference be passed onto the CC by the OFT following the first stage test.

### Costs

35. Given that this reform only relates to the consideration, publication and ongoing review of a methodology and guidance on the loss of a comparator for water companies, it seems unlikely that this would generate any material costs for Ofwat and will not require additional staff. Although Ofwat would need to define its approach to evaluating the loss of a comparator, it would potentially need to provide this evidence to the CC under the base case anyway (i.e. if a merger went ahead). The additional burden would relate to publication, however, this should be regarded as negligible.

**Option 2**

**Ofwat to publish guidance on its approach to assessing the loss of a comparator, the introduction of a new first stage test by the OFT (removal of the automatic reference to the CC) and Ofwat to provide advice on merger detriment to the OFT**

36. Under this reform, Ofwat would be required to produce guidance on the loss of a comparator as set out in Option 1 above. However, in addition the OFT would be required to apply a first stage test to any merger where both companies are above the existing £10m threshold instead of an automatic referral to the CC and they would be able to accept undertakings from the merging parties in lieu of a reference to the CC. The first stage test would include considering the advice, methods, guidance and weightings in respect of the loss of a comparator as published by Ofwat. The OFT will consider this as well as other issues when determining the need for a referral to the CC.

37. If the merger is not likely to prejudice Ofwat's ability to make comparisons or the benefits of the proposed merger outweigh the potential loss of a comparator, the OFT may decide not to refer the merger to the CC. However, the OFT will be required to consult with Ofwat before a final decision is made.

38. However, if the OFT conclude that a reference should be made to the CC, it may instead of making that reference accept undertakings from the merging companies that mitigate against any prejudicial effect to Ofwat to make comparisons. Before accepting any such undertakings the OFT must consult with Ofwat who will consider the effect of any such undertaking based on their published guidance.

39. If the undertakings proposed by the merging parties are not considered sufficient to remedy or mitigate against the loss of a comparator the merger is then referred to the CC as happens under the existing special mergers regime. But at this stage the merging parties could decide to withdraw from the merger.

**Benefits**

40. The primary benefit associated with this reform is that greater certainty is introduced into the merger process as set out in Option1 above.

41. A further benefit of the proposed reforms is that by requiring Ofwat to publish guidance on its approach to assessing the loss of a comparator and introducing a new first stage test by the OFT, the costs and time associated with assessing a water merger could be reduced. This is because prospective companies:

- could make a more informed assessment of the likelihood of obtaining clearance for its merger (which means they could decide whether or not to proceed with the merger at an earlier stage) and;
- if the OFT approves the merger during the first stage, avoid an expensive inquiry by the CC or;
- if the OFT decides to make a referral to the CC, decide to withdraw from the merger if the OFT decides that a CC referral is necessary, thereby avoiding the costs of the investigation.

42. Avoiding an investigation by the CC would save companies money and time because such investigations can be quite protracted – the CC's investigation into the Mid Kent and South East Water merger took the best part of 6 months distracting both management and staff alike from day to day running of the water company. At the same time an automatic referral implies a number of administrative costs on the parties and typically a range of consultancy fees. Therefore avoiding these costs could generate some savings when compared to the base case.

**Costs**

43. It is difficult to ascertain costs for a first stage test because it is, as yet, untested. Currently the costs of going through the OFT are very low given that the test for reference to the CC is simply one of ascertaining the presence of overlapping water companies and their turnover. Under the proposed reforms, the review becomes potentially more substantive increasing the cost to companies. For a new first stage test the range of costs could be between £50,000 to £1m right at the very top end (where parties try to get a very difficult case through –for instance a large water and sewerage company identified by Ofwat as a 'leading edge

‘ comparator). For smaller water only companies the range of costs for a first stage test could be between £50k to £250k but we cannot at this stage be sure.

44. However, this cost needs to be viewed alongside that associated with a full CC referral, which now might not be necessary, and could range between £500,000 and £2m.[8] Overall however, we cannot accurately state what the aggregate costs of Option 2 might be as we cannot know which water companies (or how large they are) might be considering a merger.

45. The Cave Review suggested that “removing the automatic reference could potentially increase the overall time required to approve a merger if the 'first stage' assessment by the OFT resulted in a reference to the CC. We accept that this could be the case but given that considerable work will already have been carried out during the “first stage test” undertaken by the OFT we would expect there to be some time and monetary savings if a referral to the CC is deemed necessary. In particular, we would expect the costs of OFT assessments made during a first stage test not to be substantively duplicated in a CC referral. Ultimately therefore, in the worst case (where CC referrals are still made), costs may be similar to the baseline option, but to the extent that the first stage test allows merger proposals to be abandoned before a CC referral, overall cost savings would be expected.

## Section 4 - Conclusion

### Conclusion

46. The introduction of guidance and a first stage test appears to be a low risk reform. The two measures complement each other, and although they will not necessarily reduce the costs of all merger references, they will introduce much greater transparency and clarity around merger references and bring the water special merger regime into closer alignment with the general merger regime. Based upon published guidance from Ofwat, Water Companies will have a clear understanding of how mergers are to be assessed, and a first stage test with a power to accept undertakings, which Ofwat support (see paragraph 10), could potentially reduce costs, particularly for smaller water only companies in looking to merge.

### Costs to business and “One-in-one Out” assessment

47. The proposed reforms are de-regulatory and could lead to cost savings for water companies through reduced administration costs where issues are resolved at the first stage referral. Potentially unsuccessful mergers are more likely to be identified before significant costs are expended by companies (and others). Although at first sight this might suggest the proposals constitute an “Out”, under the current OIOO methodology any such benefits to business cannot be formally credited as they are considered to be “indirect”. This is because they would only occur if a water company opted to merge, not automatically as a result of the proposals.

48. As such, the preferred option for this impact assessment has been categorised as “Out of scope” in terms of “one in one out”. This is on the basis that the reforms have no direct cost burdens on business and only apply to water companies that opt to merge. The preferred option will not increase the costs for water companies that are considering a merger (indeed savings may accrue – see above). The measures will also increase certainty for water companies over the way in which a merger will be assessed and enable water companies to consider the likely scale and nature of any undertakings in lieu of a reference to the CC and, on this basis decide whether to proceed with the merger.

49. There is a possibility that the proposals could potentially increase the time and, perhaps to a lesser extent, costs of a merger in a situation where the OFT still decide (after the first stage test) to refer a case to the CC. These costs would fall out of the scope of OIOO as they would only accrue if water companies proposed to merge. However, water companies would be better informed of the chances of success at earlier stages and would have the choice as to whether to pursue the merger reference and any additional costs would be avoided if they chose not to. Furthermore, we would not expect analysis at the OFT “first stage test” to be nugatory; it would in practice be expected to inform any subsequent CC assessment, yielding some saving in both time and costs at that stage.

### Post Implementation Review

50. A post-implementation review after five years will establish whether policies utilised are having the intended effect and whether they are being implemented efficiently. In this case that would be

[8] Arnold & Parker (2006) UK Competition Policy & Shareholder value: the impact of merger inquiries.

whether the Ofwat guidance has introduced greater clarity for water companies considering a merger and whether the mandatory reference to the CC, with the OFT accepting remedies in lieu of a reference, has effectively reduced the burdens on water companies. If the policy objectives are not being delivered then a change in the way that government intervenes would be needed.

## Specific impact tests

### Competition test

51. The option may encourage and provide greater potential for capital market competition (though it should be noted that the threshold for referral of mergers to OFT is not being changed as part of these proposals). Allowing more mergers without a CC referral could make it easier for some businesses to increase their market share through acquisition and may make it more difficult for smaller operators to compete in the soon to be expanded retail market for non-household customers. However, the OFT would be able to make a referral to the CC if it thought that there were competition concerns around a merger.