

**THE PROPOSED ACQUISITION OF NORWEB PLC BY NORTH WEST WATER PLC
JOINT CONSULTATION PAPER BY THE DIRECTORS GENERAL OF OFFER AND
OFWAT**

1. North West Water plc has announced its bid for Norweb plc. The Director General of Electricity Supply (DGES) and the Director General of Water Services (DGWS) (the Directors) are inviting comments on the issues raised by this bid.
2. The proposal is not such as would lead to an automatic reference to the Monopolies and Mergers Commission (MMC) under the special provisions of the Water Industry Act 1991. There is no provision for automatic reference of electricity mergers or takeovers in the Electricity Act 1989.
3. Under the Fair Trading Act 1973 (FTA), the Secretary of State for Trade and Industry may refer a proposed merger or acquisition to the MMC. It is the responsibility of the Director General of Fair Trading (DGFT) to advise the Secretary of State as to whether a merger or acquisition should be referred to the MMC. The DGFT will be consulting the DGWS and DGES on this issue.
4. This paper sets out the key issues on which the Directors will need to advise the DGFT.
5. The Directors will welcome comments on the paper by 5pm on Monday 18 September 1995. Responses can be sent by letter or fax to either of the addresses below.

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These comments will be placed in Offer and Ofwat's libraries, unless they are marked as in confidence. Any comments should also be copied to the Office of Fair Trading, at Field House, 15-25 Bream Buildings, London, EC4A 1PR.

6. Following consideration of responses the Directors will submit their advice to the DGFT.

11 September 1995

THE WIDER ISSUES

Historically in the UK, and currently in North America, there are precedents for joint utility companies. This proposed merger is, however, the first involving two privatised utilities in an overlapping geographical area in England and Wales. The merger involves two groups, North West Water plc and Norweb plc, both of whom currently have both regulated and unregulated activities. It therefore raises new issues. The Directors are concerned with the regulated businesses that would become subsidiaries within the new enlarged group.

The proposed merger would not involve the loss of a comparator for use in making regulatory judgements on efficiency and provision of services. North West Water Limited is already a ring fenced subsidiary within a group. The electricity company would also become a subsidiary of the new group. The separate regulation of the two businesses by the two regulators will, therefore, continue. Offer and Ofwat will work closely together.

The merger will bring together two existing local monopolies covering both water and electricity distribution in a substantial part of the country. It may therefore raise issues of public policy (e.g. the concentration of economic power) that go beyond the Directors' remits as sectoral regulators.

There could be benefits for customers in due course that derive from efficiency savings from the merger that could not otherwise be achieved. The value of these savings would only emerge over time. The regulatory regime must continue to operate so that benefits flow to customers.

DUTIES OF THE REGULATORS

The duties of the Directors are set out in the Water Industry Act 1991 and the Electricity Act 1989. They are not identical but are similar as far as the regulatory issues raised by the proposed merger are concerned.

It is the Directors' duties, as stated in relevant sections of their respective legislation, to ensure that companies properly carry out their functions and that they can finance the provision of those services. They also have duties to protect customers.

The Directors also have duties to promote efficiency and economy by the regulated businesses and the efficient use of utility services by consumers.

The Directors have slightly different duties towards the development of competition for the supply of services. These differences reflect the different characteristics of the water and electricity industries.

The regulatory issues arise from the effects that the proposed merger could have on the Directors' abilities to carry out their duties.

KEY REGULATORY ISSUES

Comparative Information

Both Directors attach considerable importance to their ability to use comparative information from different companies to regulate their respective industries. However, legislation on this issue is different for each industry.

Unlike the Electricity Act 1989, the Water Industry Act 1991 has provisions for automatic reference to the MMC of mergers between water companies above a certain threshold. This safeguard is to protect the ability of the DGWS to make comparisons between companies in order to carry out his duties in an industry where there is little direct competition. This would be prejudiced by a loss of a comparator. These are the circumstances in the proposed merger between Lyonnaise des Eaux and Northumbrian Water, where the MMC considered that there would be a detriment arising from the loss of a comparator, albeit that it might be capable of remedy.

In the present case, Norweb's stock market quotation would disappear and the characteristic of that of North West Water would be radically changed. This would lead to a loss of information about the way that investors view the companies.

The unique ability of the merged concern to combine its facilities management activities may affect the comparability of the regulated businesses with others in their respective sectors. However, the Directors would aim to ensure that there was no loss of comparators for efficiency and service provision. The proposed arrangements for access to information and ring-fencing discussed below would help to secure this.

Access to Information

The Directors have wide powers to acquire information from regulated companies about their regulated activities. They need to secure continued access to sufficient high quality information to allow them to carry out their duties. Licence amendments may be necessary to ensure sufficient information is provided to regulate the two separate utilities within one group. This involves information on both current performance and that needed for future reviews. On 7 September 1995, the DGES published a consultation paper on licence amendments in cases where a public electricity supplier becomes a subsidiary company. These include provisions to enable the Director to have access to information from other companies in the same group.

Efficiencies of Merged Company

The joint operations proposed could have implications for the costs of the regulated businesses.

Both Directors would wish to ensure that they had access to information on efficiencies and cost savings arising from the merger. Amendments to the licences of the two utilities would be needed to ensure this. Both regulators would take account of any savings in their respective price reviews to ensure that the benefits flow to customers.

The regulators would need to ensure that there would be an appropriate allocation of costs of the proposed facilities management company between electricity, water and other activities in the joint operations.

Consideration would also need to be given to effective arrangements to ensure appropriate confidentiality of customer information.

Ring Fencing

Strong ring fencing arrangements are necessary for the separate utilities.

Licence conditions in the water industry already require arms length transactions between group companies and the regulated business. Ofwat has issued guidelines to companies and is currently visiting companies to ensure that these are being followed. These guidelines also cover allocation of costs to the regulated business.

Offer's consultation document of 7 September contains draft licence amendments which, it is proposed, would apply in a case such as this proposed merger where the public electricity supply licence (PES) is held by a subsidiary, as against a parent company. They provide for ring fencing of the business, and would prevent the business from lending, to or extending, guarantees to the benefit of other companies in the group. They would require the Directors to certify each year that the business had adequate resources to carry on its licenced businesses.

The merger of two utilities presents a new situation and therefore Offer and Ofwat would welcome comments on whether arrangements should be further strengthened. This could be in the direction of exercising greater supervision over financial transactions such as dividends and loans between regulated businesses and the group.

Financing of Functions

Water companies and regional electricity companies have heavy investment programmes which need to be financed. Anything which could prejudice the financial viability of the parent company might, depending on the particular circumstances, be of concern to the Directors. Depending on the final terms of the bid, which currently involves a substantial cash component, there could be issues concerning the effects of the merger on the financing of functions. These concerns will require further consideration.

Effects on Competition

Both electricity and water supply are competitive for larger customers. From 1998, all electricity customers will be free to choose their electricity supplier. The merger would create a company able to provide both water and electricity supplies (and potentially also gas and telecommunications) to customers in the competitive electricity market after 1998. The implications for competition, particularly in electricity, may require further consideration.

Prices and Service Standards

Customers need to be reassured that the regulated businesses would continue to provide satisfactory services to them at reasonable prices. Both Norweb and North West Water would continue to be bound by their respective licence conditions and standards of service. The recent price reviews set price limits which allow the companies to improve their services.

Customer Representations

The North West Electricity Consumers Committee and the Ofwat North West Customer Services Committee play an important part in the regulatory arrangements. The present statutory arrangements would continue but consideration would be given to closer working relations to ensure customers' interests are fully represented.

CONSULTATION PROCESS AND NEXT STEPS

Comments on the regulatory issues are welcomed from interested parties, including regional customer representation bodies. The Directors will take these into account when deciding on appropriate licence amendments and giving advice to the DGFT on regulatory issues.

In advising the Secretary of State, the DGFT will take account of regulatory issues and any other relevant public interest issues. The DGFT can recommend that the Secretary of State refer this merger to the MMC to investigate and advise him on matters of public interest.

The Secretary of State may accept or reject the DGFT's recommendation. Alternatively, if the DGFT recommends a reference, the Secretary of State may ask the DGFT to seek binding undertakings from the parties that would remedy the public interest issues. The Directors would expect the DGFT to seek their comments on the terms of any undertakings relating to regulatory issues under the FTA which might emerge from a recommended reference to the MMC.

If the merger proceeds, the Directors would propose licence amendments to the companies. If the companies do not accept the terms of such amendments then even if there was no merger reference under the FTA, there might be licence modification references to the MMC under the provisions of the Water Industry Act 1991 and the Electricity Act 1989.