

THE PROPOSED ACQUISITION OF SWALEC PLC BY WELSH WATER PLC

JOINT CONSULTATION PAPER BY THE DIRECTORS GENERAL OF OFFER AND OFWAT

1. Welsh Water plc has announced its bid for South Wales Electricity plc (SWALEC). 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 the 19 December. Responses can be sent by letter or fax to either of the addresses below.

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6. This document is also available in the Welsh language from the above addresses. Please contact either office for a copy.

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.

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

5 December 1995

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This proposed merger is the second involving a privatised water utility and a privatised electricity utility in an overlapping geographic area in England and Wales. The merger involves Welsh Water and SWALEC, both of whom currently have both regulated and unregulated activities. It raises similar issues to those raised in the North West plc /Norweb plc merger.

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.

The Directors' duties, as stated in relevant sections of their respective legislation, are 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 have decided 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, SWALEC's stock market quotation would disappear and the characteristics of Welsh Water's quotation would be radically changed. This would lead to a loss of information about the way that investors view the companies.

In the Lyonnaise des Eaux/Northumbrian Water merger, Lyonnaise agreed with Ofwat to list its entire UK water interests on the Stock Exchange by the end of 2005. This will provide valuable information to DGWS to remedy, in part, the detriment of a loss of a comparator.

The 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. Their task of getting information could be made more difficult by the merger. Licence amendments will be necessary, as in the case of North West plc/Norweb plc, 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.

DGES has produced licence modifications to achieve improved access to information. These will be formally published after further discussion with the companies concerned.

Efficiencies of Merged Company

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

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

In setting price controls, the Directors would need to consider the appropriate allocation of costs of the proposed facilities management activities 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.

Management of Merged Company

It is important that all issues within the combined business receive the attention of an effective management. In response to the consultation paper issued by the Directors on the proposed merger of North West plc and Norweb plc, concern was expressed that there may be a loss of managerial effectiveness as a result of the merger. Due to the lack of competition, continued vigilance will be needed, particularly in the case of the regulated water business, to ensure customers are not penalised for any inefficiency.

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 will shortly be publishing licence amendments which will 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 company directors to certify each year that the business had adequate resources to carry on its licenced businesses.

Following the merger of North West and Norweb proposals for licence amendments are presently being advertised by Ofwat. OFFER will shortly be publishing licence amendments for the regulated electricity business.

DGWS intends to discuss with Dwr Cymru the factors relevant to a policy on dividend payments by the regulated water business to the group to avoid impairing the activity of the regulated water business to finance its functions.

Financing of Functions

Both Dwr Cymru and SWALEC have major investment programmes which are designed to improve efficiency and deliver better services to customers. These programmes need to be financed. In the combined business it is important to ensure that attention is properly paid to investment needs. 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 could be dealt with by licence amendments along the lines of those for North West and Norweb.

Effects on Competition

Both electricity supply 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 SWALEC and Welsh 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. This performance will need careful monitoring.

Customer Representations

The Electricity Consumers Committee and the Ofwat Wales Customer Service 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.

Use of Comparators

The proposed merger would not involve the loss of a comparator for use in making regulatory judgements on efficiency and provision of services. Dwr Cymru 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 Directors will, therefore, continue. OFFER and Ofwat will work closely together.

Wider Issues

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

CONSULTATION PROCESS AND NEXT STEPS

We received comments on the regulatory issues in response to the North West plc /Norweb plc consultation paper. Further specific comments, taking account of, among other things, the North West plc/Norweb plc merger and any special factors of this case, 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 will propose amendments to the Licences of each of the regulated 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.