

THE PROPOSED TAKEOVER OF SOUTHERN WATER PLC BY SCOTTISH POWER PLC AND SOUTHERN ELECTRIC PLC

JOINT CONSULTATION PAPER BY THE DIRECTORS GENERAL OF OFFER AND OFWAT

1. Scottish Power plc (ScottishPower) and Southern Electric plc (Southern Electric) have each announced bids for Southern Water plc (Southern Water). 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 these bids.
2. The proposals are 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 would welcome comments on the paper by 5 pm on 14 June, in order to meet the timetable set by the Office of Fair Trading. Responses can be sent by letter or fax to either of the addresses below.

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These comments will be placed in the libraries at OFFER and Ofwat, 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 on each of the bids to the DGFT.

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The first bid involves ScottishPower and Southern Water. The water and electricity companies involved operate predominantly in different geographical areas. In addition to their regulated water and electricity businesses, both companies currently have interests in businesses which fall outside the remit of the Directors. Following a completed take-over in 1995, ScottishPower also owns an English regional electricity company, *Manweb*.

The second bid involves Southern Electric and Southern Water. The supply area of Southern Electric partially overlaps with that of Southern Water. Southern Electric serves 2.6 million customers, 700,000 of which overlap with Southern Water's 1.7 million customers. Southern Electric also has interests which fall outside the remit of the Directors.

These are the first bids by power companies for a water utility. However, some of the issues raised are similar to those raised by the mergers of North West Water Group plc and Welsh Water plc with Norweb plc and Swalec plc respectively.

DUTIES OF THE REGULATORS

The duties of the Directors are set out in the Water Industry Act 1991 (Water Act) and the Electricity Act 1989 (Electricity Act). They are not identical but are similar as far as the regulatory issues raised by the proposed merger are concerned. In the case of the DGES, these duties apply to England, Wales and Scotland. In the case of the DGWS, the duties only apply to England and Wales.

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 have further duties to promote efficiency and economy by the regulated businesses and to promote 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.

Regulatory issues may arise from the effects that the proposed mergers could have on the development of competition and 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, the Water Act has provisions for automatic reference to the MMC of mergers between water companies above a certain threshold. This protects 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, an ability which would be prejudiced by a loss of a comparator. In the merger between Lyonnaise des Eaux and Northumbrian Water, the MMC decided there was a detriment arising from the loss of a comparator, albeit that it was capable of remedy.

If either bid were successful, Southern Water's stock market quotation would disappear and the characteristics of ScottishPower's or Southern Electric's quotations would be 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 stock market comparator.

In the case of the Welsh Water and Swalec merger, the DGWS accepted that an equity listing of the regulated water utility, Dŵr Cymru could not be achieved in the context of a merger but Welsh Water agreed to list preference shares in Dŵr Cymru. This will provide some, partial, market information.

An alternative source of information about the views of investors may be provided by a listing of targeted stocks. Such stocks are a class of equity designed to provide a return and information to investors about the performance of a particular business unit within a group. These stocks have been used in the USA, notably by General Motors and the USX Corporation, but would be innovative in the UK.

If either of the proposed mergers were to proceed, some functions might be combined within the enlarged group. This may affect the comparability of the regulated businesses with others in their respective sectors. 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 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. Neither of the mergers should make a difference to the availability of information about the electricity businesses.

The licences under which ScottishPower and Southern Electric operate already provide for access to information from them and each of their subsidiaries, which would include Southern Water and its subsidiaries. The task of getting information on the water utility could be made more difficult by the merger. Licence amendments will be necessary, as in the case of earlier mergers, to ensure sufficient access to information from any company within the enlarged ScottishPower or Southern Electric group. This involves information both on present performance and on that needed for future reviews of price limits.

Efficiencies of merged company

Both Directors need to ensure that they would have access to information on efficiencies and cost savings arising from the merger. Amendments to the licence of Southern Water Services Ltd (the regulated water company which is a subsidiary of Southern Water) are needed to ensure this.

ScottishPower, in its news release of 28 May, makes reference to a three per cent reduction in permitted prices for Southern Water Services' customers for the two year period from April 1998. Southern Electric in its news release of 29 May makes no reference to benefit sharing with water customers. It simply notes that an opportunity exists to build upon Southern Water Services Ltd's strong customer service record by providing a broader range of products.

The Directors welcome proposals from companies about the sharing of benefits between shareholders and customers. ScottishPower's and Southern Electric's present customers will benefit from the extension of competition to all electricity customers in 1998. The present supply price control is due to be reviewed by the DGES with a view to proposing any revised restraint on prices with effect from 1998.

The Directors would take account of any efficiency savings in their respective price reviews to ensure that the benefits arising flow to customers. In setting price controls, the Directors would need to consider the appropriate allocation of cost reductions in any joint activities between electricity, water and other businesses.

Management of the merged company

It is important that all issues within the combined business receive the attention of an effective management. In response to previous consultation papers issued by the Directors on similar mergers of utilities, concern was expressed about the loss of managerial effectiveness as a result of the merger. Due to the present lack of competition, *continued vigilance will be needed, particularly in the case of the regulated water business, to protect customers against any inefficiency.*

In the case of the Welsh Water and Swalec merger, the DGWS agreed licence amendments with Dŵr Cymru, which strengthened its management independence within the enlarged group.

These licence amendments required the water utility to conduct its business as if it was substantially the sole business undertaken and it was a separate public limited company. They required the composition of the Board to be such that it could act independently of the parent; and required that the Directors must act exclusively in the interests of the water utility if conflicts of interest arose and that they would not vote on contracts where they have interests by virtue of other directorships.

They also required the appointment of two non-executive directors of standing and relevant experience in respect of customers' interests.

Finally, they required that the dividend policy of the utility should not impair its ability to finance its functions.

The DGWS would propose similar licence amendments for Southern Water Services Ltd as a condition of any merger being allowed to proceed.

Financing of functions

ScottishPower, Southern Electric and Southern Water Services Ltd each have major investment programmes which are designed to improve efficiency and deliver better services to customers. These programmes need to be financed. In the merged 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. There could be issues concerning the effects of the merger on the financing of functions. These concerns could be dealt with by licence amendments on ring fencing, dividend policy and other matters along the lines of those detailed in this consultation paper.

Ring fencing

Ring fencing arrangements are necessary to enable effective regulation of the separate utilities.

It would be necessary to ensure that the acquired water business is ring fenced from ScottishPower's or Southern Electric's activities. Licence conditions in the water industry already require arm's 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.

The licence amendments agreed with Dŵr Cymru in respect of ring fencing strengthened these conditions. They are similar to those agreed by ScottishPower in respect of Manweb's licence to allow the acquisition of Manweb to proceed. The licence amendments would prevent the water business from lending to, or extending guarantees to the benefit of, other companies in the group. They would require the directors of the regulated company to certify each year that the water business had adequate resources to carry out its functions.

Further, the directors of the water company are required to certify to the DGWS that all contracts entered into with associated companies have the necessary provisions concerning standards of service to ensure that it can meet its obligations as a water and sewerage undertaker.

Similar licence amendments would be proposed for Southern Water Services Ltd as one condition of any merger being allowed to proceed.

DGWS intends to discuss with Southern Water Services Ltd the factors relevant to a policy on dividend payments by the regulated water business to the group to avoid impairing the ability of the regulated water business to finance its functions.

In previous takeovers where an electricity licensee has been taken over by another company, the DGES has proposed amendments to the licence of the electricity licensee which ring fence the physical and financial assets of the licensed business. The purpose of doing this has been to ensure that the ability of the electricity licensee to continue in business, and to undertake necessary investment, is not compromised if other parts of the group run into financial difficulties.

The present cases are different, since they involve an electricity company taking over another business rather than the other way round. Nevertheless, the DGES will wish to consider whether the way in which ScottishPower or Southern Electric propose to finance the takeover has implications for their ability to continue to fulfill their obligations as electricity licensees. He will also wish to consider whether arrangements are necessary in order to ensure that the future ability of the licensed electricity business to continue to finance its functions is not impaired, for example by the need to finance the requirements of the water business. Such arrangements might be similar to certain of those which the DGES has put in place in cases where

a Public Electricity Supplier has become a subsidiary of another company. They might, for example, require the Directors of the electricity licensee to make periodic statements, supported by their Auditors, to the DGES, regarding the licensee's ability to continue to finance its activities. Alternatively, or as well, they might place restrictions on the ability of the electricity licensee to guarantee borrowing for purposes other than those connected with the electricity business. In considering whether arrangements of this sort are necessary, the DGES will seek further financial information from ScottishPower and Southern Electric about the possible financial implications of the merger.

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

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.

Initial experience in the South West has suggested the importance of familiarity and local knowledge in the competition to supply utility services to domestic customers. The proposed merger of ScottishPower and Southern Water would create a company which might be better able than either ScottishPower or Southern Water alone to compete to supply electricity to customers, particularly in competition with the incumbent regional electricity companies in Southern Water's area (Southern Electric and SEEBOARD). In contrast the proposed merger of Southern Electric and Southern Water may strengthen the position of Southern Electric as incumbent electricity supplier in its own area by removing a potential competitor. It could enhance Southern Electric's ability to compete in SEEBOARD's area.

Prices and service standards

Customers need to be reassured that the regulated businesses would continue to provide satisfactory services to them at reasonable prices.

ScottishPower, Southern Electric and Southern Water Services Ltd 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 to customers. Achievement of service improvements will need careful monitoring by the Directors.

Customer representation

The Electricity Consumers Committees and Ofwat's Customer Service Committees play an important part in the regulatory arrangements. If either of the proposed mergers proceed, the present statutory arrangements would continue but consideration would be given to closer working arrangements between committees to ensure that customers' interests were fully represented and protected.

Use of comparators

Other than in respect of stock market information, neither of the proposed mergers would involve the loss of a comparator for use in making regulatory judgements on efficiency and the provision of services. Southern Water Services Ltd is already a ring fenced subsidiary within a group. The separate regulation of the utility businesses by the Directors will, therefore, continue. OFFER and Ofwat will work closely together to protect the interests of customers.

WIDER ISSUES

Either of the proposed mergers would have implications for the concentration of economic power. These include the development of multi utilities supplying electricity, water, gas and telecommunication services and regional issues relating to employment in the south of England. These are matters of public policy which go beyond the remits of either of the Directors as sectoral regulators.

CONSULTATION PROCESS AND NEXT STEPS

Comments would be welcome from interested parties, including regional customer representation bodies. The Directors will take these into account when proposing appropriate licence amendments and giving advice to the DGFT on regulatory issues arising from each of the bids.

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 these proposed mergers 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 either merger proceeds, the Directors will propose any necessary amendments to the Licences of Southern Water Services Ltd, ScottishPower and Southern Electric. If the companies do not accept the terms of such amendments then even if there was no merger reference under the FTA, there could be licence modification references to the MMC under the provisions of the Water Act and the Electricity Act.