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10 July 2015

Dear Tim,

Consultation on Ofwat's approach to future mergers and statement of method

We welcome the opportunity to respond to your publication, 'Consultation on Ofwat's approach to future mergers and statement of method'.

We have structured our response into two parts. Firstly we have set out general observations regarding future mergers under the amended special merger regime when relevant sections of the Water Act 2014 are commenced by the Secretary of State. The second part of our response sets out our views on the issues presented in the consultation. Our response takes into account Ofwat's submission to the Competition and Markets Authority (CMA) on the merger of Bournemouth and South West Water¹, in which Ofwat has applied the draft statement of method in its assessment of prejudice, benefits and possible remedies.

General observations regarding future mergers

Reducing disincentives for companies to merge

We strongly support the principle of reducing disincentives to potentially beneficial mergers and reducing the level of regulatory uncertainty surrounding a merger proposal. We particularly welcome the concept of a proposed Ofwat statement of methods and the transparency provided by a clear set of criteria that will be used to assess the impact of a merger on Ofwat's ability to make comparisons.

We can see that the criteria and statement of methods will reduce regulatory uncertainty. However, in general terms we question if the approach and in particular the assessment criteria are consistent with the overall principle to reduce the disincentives to merge.

¹ Ofwat's initial submission to the Competition and Markets Authority following the acquisition of Bournemouth Water Investments Limited by Pennon Group plc, Ofwat, June 2015.

Consultation issues

Principles for assessing mergers

The set of high level principles set out in the consultation to guide Ofwat's approach to mergers appear to be sensible and pragmatic. Our only comments relate to the following principles.

- A merger could lead to the loss of a company which had important similarities to other companies, for example operating in similar conditions facing similar issues
- A merger could lead to the loss of a company which had important differences from other companies, which for example could reduce the scope of the development of best practice

Taken together these two principles cover a large range of possibilities. It would be helpful if the term 'important' could be better defined and described in the examples given.

Proposed process for Phase 1 mergers under the new Phase 1 special merger regime

We appreciate the Water Act 2014 does not specify a timetable for water mergers and support the proposed approach to adopt the general merger regime timetable for Phase 1 water mergers including the three main stages of Pre-notification, Phase 1 investigation and Consideration of Undertakings in Lieu (UILs) of a full Phase 2 inquiry.

We recognise the importance this timetable places on the quality of evidence provided by merger parties during the pre-notification and Phase 1 process.

Draft statement of methods

We welcome the transparency provided by a clear set of criteria that will be used to assess the impact of a merger on Ofwat's ability to make comparisons. We think it is helpful to identify two primary criteria (overlapping functions and loss of an independent comparator) where the assessment is essentially a binary yes/no response. This should help to expedite mergers where it is clear there will be no prejudice to Ofwat's ability to make comparisons.

We think the equal weighting applied to each of the remaining criteria as well as the attempt to monetise impacts over time is all helpful. The initial submission provided by Ofwat to the CMA on the merger of Bournemouth and South West Water shows this. We support the continued use of relevant customer benefits under the Water Industry Act in the form of lower prices, higher quality, increased choice or greater innovation. We also recognise the need for compelling evidence before Ofwat can recommend to the CMA that customer benefits outweigh the likely prejudice from the impact of the merger.

While the consultation does not include all UILs that could be offered by the merging parties, to avoid a Phase 2 inquiry, it does provide a helpful summary that includes full and partial divestiture as well as separate administration. The consultation also refers to amended licences. While the example of modular licences for separate services within a merged entity is included, as an example in the consultation, it does not describe the UIL in the way in which it has been set out in the submission provided by Ofwat to the CMA on the merger of Bournemouth and South West Water.

In the case of Bournemouth and South West Water Ofwat state that possible behavioural remedies could include a commitment to licence amendments to allow Ofwat to regulate the sector differently in the future where these amendments could be introduced in a way that other companies could adopt them in the future. Ofwat suggest a further remedy that could be offered by merger parties is acceptance of licence modifications to allow modular licences to be introduced to all.

We are concerned that the Bournemouth and South West Water merger is being used to pursue Ofwat's policy objectives for licence modernisation. We think it is important that the consultation document should be consistent with CMA submission and that Ofwat should be more explicit about how it will seek to use merger remedies from individual companies to establish regulatory precedent for the whole sector.

Finally, where potential remedies could be accepted we think it is important that Ofwat also carry out an assessment of the value of the remedy using an approach that is consistent with the valuation of the loss of comparator. In the case of Bournemouth and South West Water it would be helpful to understand how potential behavioural remedies, such as licence amendments, are valued.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "C. Offer", with a stylized flourish at the end.

Christopher Offer
Acting Director of Regulation

cc. Gabrielle Edwards, Defra
cc. Peter Swan, Competition and Markets Authority