



Mergers
Ofwat
Centre City Tower
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8 July 2015

Dear Sirs,

Anglian Water's response to Ofwat's consultation on a new approach to future mergers and statement of method

Summary

1. On 28 May Ofwat issued a consultation document, outlining its proposed approach to future mergers¹. This paper sets out Anglian Water's response to that consultation.
2. Anglian Water is supportive of the general thrust of Ofwat's proposals. They appear to represent a change in approach that will allow for a more rounded assessment of mergers involving water companies than in the past.
3. Previously, there was a strong presumption against water mergers if they reduced Ofwat's ability to use comparisons between companies as a regulatory tool. There was also an automatic reference to a Stage 2 merger enquiry by the Competition & Markets Authority (CMA) if at least one of the water companies involved has a turnover of at least £10 million. In reality, this captured practically all potential mergers of water companies and in effect removed the possibility of a stage 1 clearance of a merger even if benefits were felt to outweigh downsides.

Assessment of the main changes

4. The key proposed change seems to be that each proposed merger will be judged on its merits. This is a helpful development, and the two-

¹ http://www.ofwat.gov.uk/regulating/pap_con201505mergers.pdf

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phase process should enable more issues to be considered as part of an extended Phase 1 enquiry.

5. This should then allow Ofwat to provide an opinion to the CMA as to whether there is a need for the merger to go on to the phase 2 assessment. The CMA can then decide not to refer the merger to the six month phase 2 assessment if it believes:

- the merger is not likely to prejudice Ofwat's ability to make comparisons;
- the likely prejudice is outweighed by relevant customer benefits; or
- the company has offered appropriate undertakings in lieu of a reference which remedy, mitigate or prevent the prejudicial effect on Ofwat's ability to make comparisons.

6. These changes are helpful in that they begin to "normalise" the water merger regime, with a merger more likely to be able to proceed if the relevant customer benefits are considered likely to outweigh any downsides linked to Ofwat's ability to use comparisons in future.

7. The new approach also allows Ofwat and the CMA to consider "undertakings in lieu of a reference" from the merging entities. These undertakings could mitigate any concerns about the merger sufficiently to enable Ofwat to recommend, and the CMA to conclude, that a Phase 2 reference is not needed.

8. The approach proposed in the consultation seems, broadly, to be an improvement on the rather mechanistic existing regime. It is more closely aligned to the approach the CMA takes to other mergers in the economy, where the question asked is whether the merger would lead to a "substantial lessening of competition", and whether there are countervailing customer benefits (or undertakings in lieu of a reference) that could allow the merger to be cleared without proceeding to phase 2.

9. The key difference for water mergers is that the new approach allows for consideration of whether the merger could lead to a substantial lessening of *comparative* competition. In Ofwat's words, this means considering whether the merger could "prejudice our ability to make comparisons between water enterprises."

10. Ofwat sets out a number of high level principles that it proposes will guide its approach in assessing mergers in the future. These seem to be sensible and well considered, although perhaps suggesting a fairly conservative mindset will still prevail.

11. An additional potential issue is that of a "first mover advantage" in relation to mergers. The principle in question states:
"Each merger may permanently reduce the number of independent comparators in the monopoly parts of the value chain; and as a result the detriment to the comparative regime may increase for each successive merger".

12. This suggests that mergers that are considered early on in the new regime may have more chance of progressing than subsequent proposed

mergers. This may seem unfair, but it is hard to see how this can be overcome, if Ofwat still places value on retaining a good number of comparators for the purposes of informing its regulatory decisions.

Potential for more radical change?

13. Ofwat gives a number of reasons why comparisons remain important to it in the approach to regulation of water companies. It is clear that in some areas, comparisons between water companies remain important for Ofwat. However, some of the justifications given (such as the ability to compare standards of board leadership, transparency and governance) could be done through benchmarking of companies outside the water sector.

14. Whilst supporting the direction of travel, Anglian Water would suggest that in many ways, the position set out in the consultation remains close to the view Ofwat took in debates around the merger provisions set out in the Enterprise Act in 2002. The supporting report on how to quantify the impact of losing a comparator also draws a lot on the approaches the Competition Commission took in previous cases. And yet the UK water market is more dynamic now than in 2002, and is expected to develop further in the future. Moreover, Ofwat now has greater scope to use mechanisms other than comparators to drive efficiency. These factors could justify more of a change than is being proposed.

15. In the speech Ofwat's Chairman gave in March at the Policy Exchange event, he noted that comparative regulation can be a "constraint". He also noted that comparators may not be useful if they don't lead to frontier shift. These considerations also suggest that Ofwat could move further towards an even more open-minded approach to the potential benefits of mergers than is flagged in this consultation, perhaps through reducing the weight placed on the loss of a comparator in the overall assessment of the merits of a merger.

Next steps

16. We hope these comments are helpful. Should you have any questions or comments on the content of this letter or appendix, please contact me by email at aPlant2@anglianwater.co.uk or by telephone on 01480 326039.

Yours sincerely,



Alex Plant
Head of Regulatory Strategy & Market Reform

Appendix: Detailed Points

Whilst Anglian Water is broadly supportive of the revised approach to mergers that Ofwat has outlined, and recognising that best practice approaches from the CMA system for assessing mergers have been used where possible, we offer some detailed comments in relation to the consultation document which we hope are helpful to Ofwat in its further deliberations.

These are set out by reference to the relevant pages in the consultation document:

Page 4 of Overview, para 2.2.3 of main document:

The references here imply that benchmarking of issues such as leadership, transparency and governance can only be done by comparing water companies with other water companies. Anglian Water suggests that such benchmarking could – if needed - be carried out with reference to companies outside the water sector.

Page 5 of overview, paras 2.1 and 3.1 of main document:

The fifth bullet brings out the potential for “first mover advantage” in relation to water company mergers, but there is no consideration of whether this issue can be addressed.

Page 6 of overview, para 3.7 and chapter 5, and para 6.25 of main document:

Anglian Water would imagine that an iterative approach to Undertakings in Lieu would be taken, with discussions between the parties wishing to merge and Ofwat allowing for a refinement of proposals to happen. This is hinted at in section 6.25 of the main document, but could it be made clearer?

Appendix A1: Statement of Methods

Should the types of benefits outlined in section 4.5 also be referenced within the Statement of Methods as issues that Ofwat may wish to take into account if relevant to future proposed mergers?