

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

## Introduction and general comments

This is Bournemouth Water's response to the consultation on Ofwat's approach to future mergers and statement of method. We view it as a positive step to set out the process clearly and the detailed considerations that would underpin any merger analysis, as well as expectations from any resulting merger.

We are perhaps in a unique situation at the time of responding to this consultation, however whilst this experience may have informed our views, we express no opinion on the current proposed merger of South West Water and Bournemouth Water; the views stated in this document are an objective response to Ofwat's proposed approach.

We welcome the approach to set out the methodology in advance; however do have concerns over the proposed process, particularly in relation to the timescales proposed. The ability to have full discussions at the 'pre-notification' stage as well as sufficient time during Phase 1 to work through the evidence requirements and reach agreement on undertakings in lieu, where appropriate, is extremely ambitious.

**This document covers the three areas where Ofwat have stated that responses would be welcomed:**

- Principles and approach to mergers
- Proposed process for Phase 1 mergers under the new Phase 1 special merger regime; and
- Our draft statement of methods

- **Principles and approach to mergers:**

We welcome Ofwat's important role under the new special merger regime following the Water Act 2014.

We agree with the benefits that comparative regulation brings to the industry are key to benchmarking, setting stretch targets, driving innovation and improved performance and of course, ultimately delivering a better service to customers and offering protection from excessive prices through the price control process.

We accept and agree that Ofwat should continue to update its approach to comparators.

We understand that the loss of a high performing company from that comparator base could be of detriment to all customers.

However, whilst Ofwat states that ‘the loss of a water comparator is likely to have less impact than the loss of a sewerage comparator’<sup>1</sup>, there appears to be no modification in the approach for this.

In relation to relevant customer benefits; the cost of implementing synergy benefits must not be underestimated and over a reasonable period of time; they cannot be implemented from day 1.

We think that the approach to UILs is a significant risk to achieving the Phase 1 review within the time allowed as it’s unlikely that Ofwat and the merger party will reach agreement quickly on the level of potential prejudice caused, we note however that the ultimate decision rests with the CMA.

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

We welcome the pre-notification phase and the encouragement to have open dialogue with Ofwat and the CMA and assume that the current CMA Enforcement Order process will not apply in order for both parties to share information. We note that Ofwat may advise the CMA not to start Phase 1 until suitable information has been presented for this phase.

Whilst the guidance is helpful, we caution that the expectations for this phase are ambitious for a time when the ‘merger parties’ would also be working through a due diligence and negotiation process and that market sensitivities need to be considered if any of the merging parties are listed companies. Assurances would need to be provided that any pre-notification discussions with Ofwat and the CMA would be on a completely confidential basis.

It’s also not clear on whether the CMA once notified of any proposed merger could prejudice the transaction.

The consultation consistently refers to ‘merger parties’ and in doing so implies joint ownership of the evidence required, however it should be recognised that it may be that the ‘merger’ is more of an acquisition and that the discussions may only be possible with one party. It should also be recognised that there may be a situation where the merger parties have different views of the possible detriment to the industry and benefits to customers.

It should be a consideration that the merger or acquisition may be at a shareholder level and potentially overseas based, and therefore the level of engagement with the wider management team that would be required to fulfil the requirements of the pre-notification phase, particularly in relation to the ‘quality of evidence’ required, could be limited at a time when the proposed transaction is highly confidential.

We think that completing Phase 1 within 40 working days whilst helped by the publication of Ofwat’s guidance in the statement of method is extremely ambitious and does not take account of the amount of evidence required to be produced by limited resource both at the merger parties as well as Ofwat and the CMA.

In addition, we are not confident that the timescale allows sufficient time for the assessment of evidence, response and discussions as well as gaining agreement on UIL's.

Gathering comparative performance evidence and information for Ofwat models will become increasingly more difficult the further away from a completed price review.

We welcome the approach to licence modifications but note that account should be taken of the potential impact on synergy benefits of maintaining separate accounting or reporting requirements for example.

- **Our draft statement of methods:**

We agree with the criteria outline in the statement of method, with one exception:

It's not clear from the approach outlined how much weight the ability to make comparisons in the future or newly created and innovative comparators will in reality have against the clear methodology of detriment due to loss of a comparator; whilst the statement of method states that Criterion 7 has equal weighting, it is potentially more subjective and less straightforward to quantify and model. More transparency on this would be helpful to assess the options in advance.

## **Summary**

Whilst we welcome the new approach and agree with the statement of method, we have concerns over the proposed process. Given the context of the commercial reality of such transactions, the volume of evidence required in short timescales both for this process and due diligence, the resource required by all parties including Ofwat and the CMA at short notice; it would seem unlikely that the new approach is achievable in the proposed timescales and in reality shorten the current process significantly.

We would encourage a review of the proposed Phase1 timescales to allow some extra time in order for the process to be properly completed so that a Phase 2 referral could be avoided, with a caveat that a Phase 2 referral could be made at any earlier date if it is clear that the merger will not be resolved at Phase 1.

*Bournemouth Water*

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