

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

**A response by Northumbrian Water Limited (NWL)**

**Introduction**

NWL supports the provisions in the Water Act 2014 aimed at reducing the disincentives for companies to merge, and the level of regulatory uncertainty when a merger is proposed. We, therefore, welcome this consultation on Ofwat's approach to future mergers.

The criteria outlined in the consultation are wide ranging and comprehensive. Ofwat state that the changes proposed will reduce the burden for mergers that provide benefits to customers. In our view, for the reasons we outline below, these process changes are likely in practice to have little impact on the likelihood of customer-beneficial consolidation.

**No reduction in regulatory uncertainty**

In practice, Ofwat's proposals for the Phase 1 stage simply shorten the time period for the review that would happen in Phase 2 at the CMA. Phase 1 does not appear to have reduced regulatory requirements because all the likely Phase 2 tests are within the Phase 1 assessment. They do not address regulatory uncertainty, which remains until the outcome of the Phase 1 review, at which point the preparatory costs and management time have already been incurred.

As the consultation notes, there will need to be a very significant amount of costs incurred upfront, in the pre-notification stage, by the companies in preparing the merger impact assessment. It will be necessary to address all of the valuation methods set out in the Europe Economics report for the five comparative Ofwat models. This will need to take into account the seven criteria for testing the level of prejudice to making comparisons and also the five criteria for assessing customer benefits. This will be a complex, time consuming and costly process.

Therefore, there remains a significant disincentive in terms of the cost of preparation, fees and management time in preparing a merger case which could then be overturned or found to be unviable, whether in Phase 1 or Phase 2 of the process. Regulatory uncertainty is not reduced until the outcome of the Phase 1 review (ex-post).

**Ways to reduce disincentives**

In our view, it would reduce regulatory uncertainty if Ofwat could be much clearer ex-ante on how the costs of a loss of a comparator would be calculated or assessed. It should be possible for Ofwat to publish in advance the cost of a loss of a water or sewerage independent comparator as all the data will be derived from Ofwat's efficiency models. A similar approach has been taken by Ofgem in the past for network mergers.

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If Ofwat were able to publish the Europe Economics valuation models (or their own), this would be a great help in providing the companies with the tools they require to prepare their merger impact assessments and be clearer about the likely outcome of an application. The alternative is a great deal of duplicated work by companies as they try to recreate the Europe Economic models, and the potential for lengthy conflicts over differing modelling calculations.

### **Conclusion**

In conclusion, we believe that the costs and uncertainty that would remain in the merger process following the implementation of Ofwat's proposals would continue to deter companies from proposing customer beneficial consolidation. To remedy this situation, we have suggested that Ofwat could:

- provide more information about the costs of the loss of a comparator; and
- publish in advance the models that it will use for assessing merger costs and benefits.

We would be happy to discuss this further should there be any points to clarify or develop.

Northumbrian Water Limited

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