

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

Severn Trent Water response  
10 July 2015

## Our response to your proposed policy

We welcome this merger guidance and the supporting Europe Economics paper. This helps create clarity on the expectations of the merging parties and helps to reduce any surprises during the process.

Our responses below focus on how to make the Special Merger Regime framework most efficient for capital markets innovation and injecting dynamic change into the structure of a sector that has experienced limited structural change for 25 years. There are a number of changes that could create long term benefits for customers by revealing new sectoral structures and transferring risk to those best placed to manage it. Any merger assessment framework needs to recognise that there are benefits for customers from capital markets innovation that may be difficult to precisely quantify.

Overall the main area we believe needs further consideration and debate is Ofwat's policy position on the need for independent comparators. The regulatory framework has moved on since the early days of privatisation when Ofwat made the case at various merger enquiries for the need for many independently owned comparators. Indeed, the methods which Ofwat dismissed at the time which could have lessened the loss of a comparator are now the methods used at the PR14 price review, notably the use of panel and sub-company data. We believe the policy position on independent ownership needs to align with the price setting framework Ofwat have deployed.

Throughout the document we have set out a number of recommendations, which are:

1. we suggest Ofwat reconsider its policy position on the independence of comparators, in particular its views on the econometric modelling effects of companies under common ownership and to consult more widely on this important policy issue. As a start, we think Ofwat should reconsider the phrases in the merger guidance relating to the value of independent ownership, in particular the statement on pg 43 of "*unless a company is under independent ownership then it is unlikely to be a fully independent observation*".
2. Ofwat should include a clearer definition of water mergers that would be included within the scope of these guidelines by improving clarity on how the 4 new price controls will be treated differently within the assessment.
3. Ofwat should make its assessment and recommendation on whether a merger exists based on the turnover of the price-controls involved in the merger. This should make clear how intermediary uncontrollable pass-through costs (e.g. wholesale charges) are considered in the assessment. This is consistent with how the turnover test would be applied if a division of two larger companies were merged under the general merger regime – only the turnover of the relevant divisions would be considered.
4. Ofwat should place more weight on existing regulatory mechanisms defined in a Price Control settlement to clawback benefits for customers from cost savings, in line with Ofgem's approach.

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5. Ofwat should consider the potential acceleration of benefits that a merger could deliver for customers (even if it is deliverable in theory through contracted means) and consider the practicalities of contractual mechanisms proposed as counter-factuals. A balance needs to be struck between the theoretical delivery of benefits for customers through other contractual mechanisms compared to the certain delivery through a merger integration. Consider rephrasing the sentence on pg 50 to “are a direct result of the merger (and unlikely to reasonably practically occur otherwise or within as rapid a timeframe)”.
6. Ofwat to review whether it is setting an evenly balanced assessment framework.
7. Ofwat to re-consider its interpretation of sustained benefits. As a starting point it should consider rephrasing the sentence in pg 50 to “accrue within a reasonable period of time ~~and are sustained~~”

Below we set out our views in detail. We would be happy to discuss further with you on these important policy points.

Neil Corrigan	Head of Strategy	<a href="mailto:neil.corrigan@severntrent.co.uk">neil.corrigan@severntrent.co.uk</a>
Tony Ballance	Director, Strategy and Regulation	tony.ballance@severntrent.co.uk

## **Section 1: Ofwat's principles and approach to mergers**

### 1.1 Overall approach

Overall, we consider that restrictions on mergers in the water industry may well have disadvantaged customers by restricting the level of capital market competition in the sector. We support the conclusions of the Independent Review of Competition and Innovation in Water Markets, carried out by Professor Martin Cave for Defra, that: "*The special merger regime represents a significant barrier to further consolidation, adversely affecting the scope for efficiency gains, financing costs and resource optimisation*". Reducing restrictions on mergers would increase pressure on companies' management to reduce costs, as companies that were inefficient would face a greater threat of being taken over. It would also enable economies of scale to be achieved.

We made these points in our response to the Defra 2012 consultation on reforms to the Special Merger Regime (SMR) and believe the scrapping of the SMR - so that water mergers would fall under the CMA's general merger guidance - would be sufficient to protect customers. It is notable that other regulators such as Ofgem, the CAA and Ofcom are able to rely on the general merger regime to protect customers. However, we recognise the legal framework set up under the Water Industry Act 2014 and under those laws there is a need to test whether a merger harms Ofwat's ability to make comparisons.

### 1.2 Policy position on independent comparators

Ofwat retains the position (pg 22) that losing an independent company reduces the number of comparators available. We would strongly challenge this long held belief given advances in econometric modelling, the regulatory framework and other regulator's positions on the same issue. We believe this is a critical policy point that needs wider debate than a 6 week consultation, as it is at the heart of how Ofwat are able to make use of comparators in protecting customers.

Many of the arguments for the need for independent observations stem from the merger of Vivendi and First Aqua in 2002<sup>1</sup>. In the final merger report, the DGWS (Ofwat) made the point that reducing the number of independent observations harms Ofwat's ability to make comparisons in two critical areas (pg 100, para 5.3):

- Qualitative comparisons through increased diversity of management and being able to be used as a benchmark company
- Quantitative comparisons by having fewer independent observations in the dataset

The arguments set forward by the DGWS on quantitative comparisons related to the effect on the statistical robustness of Ordinary Least Squares (OLS) analysis of the industry. In the arguments set forth, the DGWS argued that alternative econometric techniques such as panel data "*would not improve upon the current approach* (pg 104, para 5.23) and furthermore given the industry characteristics "*panel data analysis was inappropriate*". There are four changes to the econometric approach used in PR14 which puts these core arguments behind the need for independent observations into question:

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<sup>1</sup> Competition Commission – Vivendi Water UK Plc and First Aqua (JVCo) Limited: A report on the proposed merger, November 2002

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- Inclusion of panel data: Ofwat's PR14 totex econometric approach included panel data and other techniques to increase the number of datapoints and improve explanatory power of the models. In the Bristol appeal to the CMA, Ofwat stated<sup>2</sup> *"We have developed a range of benchmarking models which reflected broader feedback received about the advantages of totex modelling and previous comments by the Competition Commission that we should make greater use of panel data modelling."* This clearly is a change in policy approach to the view taken in 2002 which at the time was a core argument on the need to retain independence in the dataset used for regression modelling. The widening of the dataset over multiple years results in observations from the same company in setting the benchmark.
- Move from frontier to upper quartile: the PR14 approach used an upper quartile rather than efficiency frontier approach. The move to upper quartile relies less on an actual company being the frontier, but rather an aggregation of multiple datapoints in creating the upper quartile level. Hence there is less need for independence in the underlying data points, but rather to create a larger number of datapoints. Hence the arguments that each datapoint needs to be independent of the others is no longer a necessary condition.
- Triangulation through multiple approaches: The PR14 models used a triangulation approach in getting to an assessment of upper quartile efficiency. Ofwat's evidence to the CMA<sup>3</sup>-highlighted the diverse approach used through triangulation of multiple modelling approaches.
- Sub-company data: In the Vivendi case, the CC recommended that the DGWS could mitigate the effect of loss of a comparator through sub-company data. At the time the DGWS's concerns were that a sub-company approach would take time to establish as it would need a robust time-series dataset and would impose a regulatory burden on Ofwat and companies (pg 105 para 5.33). Ofwat's policy on this has changed as it introduced sub-company data reporting since 2009. At the next price control in 2019, it would have 10 years of sub-company data to base its assessments. We consider this is an appropriate junction to assess whether the collection of 10 years of sub-company across the industry would have some benefit in offsetting the loss of a comparator.

Overall these changes to the econometric approach have changed the underlying case behind the need for independent observations. If two networks were brought under common ownership but reported two separate sets of information, they could still be used effectively in econometric modelling.

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<sup>2</sup> [https://assets.digital.cabinet-office.gov.uk/media/54f86c11e5274a1417000003/Ofwat\\_opening\\_statement\\_v2.pdf](https://assets.digital.cabinet-office.gov.uk/media/54f86c11e5274a1417000003/Ofwat_opening_statement_v2.pdf)

<sup>3</sup> CMA Bristol water appeal 2015;

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Other regulated sectors have fewer independent owners than the water and sewerage industry.

Industry	No of companies	No of independent owners
Gas transmission	1	1
Electric transmission	3	3
Gas distribution	8	4
Electric distribution	14	6
Wastewater	10	10
Water	18	18

These other regulated sectors, such as electricity and gas distribution and transmission, rely less on comparators and have moved their regulatory regimes towards a wider mix of incentives that encourage companies to seek efficiencies. There are less onerous requirements on the need for comparators and where comparative measurement is needed, the use of horizontal audits seeks to compare on a like-for-like basis. This demonstrates other regulator's ability to successfully regulate network industries with fewer independent owners.

We asked Ofgem how its econometric modelling was able to deal with companies under common ownership and what adjustments were made. Their response was:

1. For both our RIIO-ED1 and RIIO-GD1 price controls we have used the observations for individual DNOs in our econometric benchmarking models whether or not they are in common ownership. We consider that the benefits of including the individual observations in terms of increasing the sample size in our econometrics and improving the robustness of the models outweigh the potential disadvantages relating to some of network companies' activities being common ( e.g. finance, HR and regulation) such as differing degrees of economies of scale and cost allocation issues. We have taken some account of common ownership through the use of cluster robust standard errors in our modelling. This takes account of the fact that the set of observations in the panel are not independent but clustered by DNO. We have also carried out some sensitivity analysis on a DNO group basis.
2. We have not made adjustments to the network companies' data to reflect whether or not they are in common ownership. We considered whether to make a fixed cost adjustment for singleton DNOs but decided this was not appropriate as it was not an inherent characteristic of the networks. It's an issue of scale that applies to all DNOs to varying degrees. If we applied a fixed cost scalar to each of the DNO allowances we would need to change it if a DNO was subsequently purchased by, or divested from, a DNO group. We did not think that this was appropriate. (See paragraph 4.15 in our draft determinations expenditure assessment document [https://www.ofgem.gov.uk/sites/default/files/docs/2014/07/riio-ed1\\_draft\\_determination\\_expenditure\\_assessment.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2014/07/riio-ed1_draft_determination_expenditure_assessment.pdf) and paragraph 4.36 and 4.37 of our final determinations expenditure assessment document. [https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1\\_final\\_determination\\_expenditure\\_assessment\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_expenditure_assessment_0.pdf)

We've carried out some analysis on a group basis to reflect the nature of the activities being carried out. For both RIIO-GD1 and RIIO-ED1 we have assessed

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business costs such as CEO office costs, finance and regulation and HR using ratio analysis on a company group basis reflecting that these activities are typically carried out by a single support function in each group. Details of our approach to cost assessment for RIIO-ED1 including econometric benchmarking are set out in following document ([https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1\\_final\\_determination\\_expenditure\\_assessment\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_expenditure_assessment_0.pdf)) Details of our approach to cost assessment for RIIO-GD1 are set out in the following document ([https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/4 - riiogd1 fp cost efficiency 0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/4_-_riiogd1_fp_cost_efficiency_0.pdf))

Source: Ofgem FOI request received 8 July 2015

Based on this response it is informative to see how Ofgem have been able to successfully regulate network industries with fewer company comparators, and significantly fewer independent owners than in the water sector.

In 2002 Ofgem set out their policy statement on distribution network mergers and the need for independent comparators<sup>4</sup>. This conveyed a similar position to Ofwat's at the time and imposed a licence modification requiring a reduction of £32m for each subsequent merger. However they subsequently revoked that position in 2010 and have since relied on the CMA general process to consider all the facets involved in a merger.

Based on this evidence, we consider it is timely for Ofwat to re-assess its position on the need for independence of comparators in its econometric modelling approach.

**Recommendation 1** – we suggest Ofwat reconsider its policy position on the independence of comparators, in particular its views on the econometric modelling effects of companies under common ownership and to consult more widely on this important policy issue. As a start, we think Ofwat should reconsider the phrases in the merger guidance relating to the value of independent ownership, in particular the statement on pg 43 of “*unless a company is under independent ownership then it is unlikely to be a fully independent observation*”.

### 1.3 Definitions of which parts of the value chain the principles apply to.

Pg28 of the guidance sets out the key principles. Within this, there is a mixed terminology between companies, appointees, licencees and monopoly parts of the value chain. We consider it would be helpful to tighten up these definitions as set out in the table below. Overall, most of the principles are related to the monopoly parts of the value chain. Hence as parts of the value chain move towards contestability, some of the principles may become less relevant.

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<sup>4</sup> <https://www.ofgem.gov.uk/ofgem-publications/37817/mergersandaquisitions-48.pdf>

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<b>Merger principles</b>	<b>To which part of the value chain would this apply</b>	<b>To which part of the value chain would this <u>not</u> apply</b>
Each merger will be considered on its merits, taking full account of its benefits	Monopoly and contestable parts of value chain	
Any merger has the potential to prejudice Ofwat's ability to make comparisons	Monopoly parts of value chain	Contestable parts of the value chain
A merger between companies whose scope of activities does not overlap is unlikely to significantly prejudice our ability to make comparisons.	Monopoly parts of value chain	Contestable parts of the value chain
A merger involving a high performing company in terms of efficiency/service can prejudice our ability to set cross industry benchmarks.	Monopoly parts of value chain	Contestable parts of the value chain
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.	Monopoly parts of value chain	Contestable parts of the value chain
A merger can lead to the loss of a company with important similarities to the remaining companies. It might, for example, operate in similar conditions and face similar issues.	Monopoly parts of value chain	Contestable parts of the value chain
A merger can lead to the loss of a company with important differences to the remaining companies, which for example could reduce the scope of the development of best practice.	Monopoly parts of value chain	Contestable parts of the value chain
It might be possible for us to amend our approach to offset, to an extent, the impact of the loss of a comparator;	Monopoly and contestable parts of value chain	
A merger has the potential to create customer benefits which could outweigh the prejudice to our ability to make comparisons.	Monopoly parts of value chain	Contestable parts of the value chain
UILs may be appropriate to remedy, mitigate or prevent the prejudice to our ability to make comparisons	Monopoly parts of value chain	Contestable parts of the value chain

**Recommendation 2** – Ofwat should include a clearer definition of water mergers that would be included within the scope of these guidelines by improving clarity on how the 4 new price controls will be treated differently within the assessment.

#### 1.4 Turnover

Page 18 of the guidance discusses the turnover test which would define whether a merger should be assessed during a CMA Phase 1 investigation. We believe given the introduction of 4 binding sub-controls that this definition needs further clarification. In essence a WASC appointee has 4 separate price regulated businesses under its licence. The turnover test should apply to the parts of those price controls that are subject to the merger. The turnover test was established to ensure that material mergers affecting Ofwat's ability to make comparison were not compromised and at the time did not consider the implications of value chain fragmentation.

For example, if two appointees' non-household businesses were to be merged, it should be the price control revenue that forms that test. This raises a further clarification issue on the definition of turnover for intermediary parts of a value chain. In the table below, we illustrate using Ofwat's published PR14 models that the price control revenue associated with NHH retail (£171m) is significantly smaller than the end user revenues those entities would collect (£2,719m) due to a large portion of pass-through wholesale costs (£2,548m) covering 94% of the income collected.

Applying the turnover test to the price controlled revenue would imply that 13 of the 18 NHH retailers fall under the £10m threshold. However if the pass-through wholesale costs are included this falls to 2 retailers. If this is not clearly set out in the merger guidance, then there could be numerous mergers of small NHH retail arms earning less than £1m gross margin being subject to a CMA Phase 1 investigation. This would create a disproportionate regulatory burden as those same business operating in a competitive business would need to exceed £70m under the CMA's general merger rules. This pass-through issue is more impactful on downstream activities (eg retail) compared to upstream activities (eg water resources) as the downstream player needs to pass-through all the upstream costs to its customers.

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2015-16, based on PR14 models			
	NHH revenue (retail service and wholesale)	Apportioned wholesale charge for NHH retail	NHH total revenue price control including net margins
UU	527.7	491.8	35.9
TMSexcITT	389.3	360.3	29.1
SVT	403.8	377.8	26.0
ANG	247.5	232.3	15.2
YKS	210.0	199.6	10.4
NES	191.4	181.7	9.7
WSH	163.2	153.6	9.6
SRN	139.8	131.2	8.6
WSX	122.0	115.8	6.2
AFW	59.6	54.3	5.3
SWW	125.6	120.3	5.2
SEW	48.9	45.4	3.5
SSC	26.6	23.9	2.7
BRS	24.4	22.8	1.5
SES	10.4	9.6	0.7
SBW	13.2	12.5	0.7
PRT	9.4	8.8	0.6
DVW	6.3	5.9	0.3
<b>Total</b>	<b>2,719.2</b>	<b>2,547.8</b>	<b>171.3</b>
companies below £10m threshold			

This approach needs to apply not only to those parts of the value chain subject to contestability today (eg NHH retail), but also those that are anticipated to be subject to contestability at future price reviews (eg sludge and water resources).

**Recommendation 3** –Ofwat should make its assessment and recommendation on whether a merger exists based on the turnover of the price-controls involved in the merger. This should make clear how intermediary uncontrollable pass-through costs (e.g. wholesale charges) are considered in the assessment. This is consistent with how the turnover test would be applied if a division of two larger companies were merged under the general merger regime – only the turnover of the relevant divisions would be considered.

## **Section 2: Ofwat's proposed process for Phase 1 mergers under the new Phase 1 special merger regime**

### 2.1 Customer benefit tests

Under the guidance pg 33, Ofwat state that they would place less weight on cost reductions which are less certain to be passed on to customers in the form of lower prices, for example through totex mechanisms. We find this an unusual position to take, as the introduction of clear totex sharing mechanisms creates transparency on cost savings being passed across to customers and visibility to Customer Challenge Groups (CCGs). Customers will benefit by around 50% of any savings made through an agreed regulatory mechanism. Companies are subject to this regime and true-ups will occur at the following price review. There is no choice but to pass on the savings.

This policy position is in direct contrast to Ofgem's merger policy statement of 2010<sup>5</sup> where they make it clear that they will use existing mechanisms to recoup gains for customers *"for the remainder of the existing price control any merger benefits will be shared with customers at the same rate all other cost savings are shared. For electricity distribution this is around 50 per cent – so customers stand to gain half of all benefits from efficiencies in that sector, whether these are created by a merger or other initiatives."*

Companies have an over-riding profit motive to reduce costs in order to gain from the totex sharing mechanisms. A company would only propose a merger if it unlocked additional savings, of which customers receive 50%. Unless Ofwat thought its clawback mechanism was inadequate or subject to regulatory gaming, we do not understand why greater weight should be placed on the regulatory framework's ability to clawback value for customers.

**Recommendation 4** –Ofwat should place more weight on existing regulatory mechanisms defined in a Price Control settlement to clawback benefits for customers from cost savings, in line with Ofgem's approach.

### 2.2 Certainty and pace of benefits delivery

In the merger guidance (pg 37), it refers to considering whether the benefit would be unlikely to accrue without the merger and not be achieved through other forms of permitted agreement between the parties.

In the case of water resources, history would show that very few new water resource sharing agreements have arisen since privatisation despite the ability for companies to enter bulk supply agreements. The limited examples such as Mid Kent-South East have resulted from a merger. This empirical evidence would show there are wider behavioural factors at play beyond economic theory that a merger can help overcome to create customers benefit.

As an example, the Mid Kent / South East and Wessex / South West merger inquiries considered whether flexible bulk supply arrangements could deliver the same benefits. We consider this argument fails to recognise the practicalities and the delays this may create for customers. In the Wessex / South West merger case, combined water resource planning was a potential benefit – 15 years on we are not sure if customers have

<sup>5</sup> <https://www.ofgem.gov.uk/ofgem-publications/76361/network-mergers-info-note-aw-final.pdf>

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benefitted to the same degree and at the same pace from joint water resource planning through contracted means as compared to a merger.

Ofgem have taken a contrary stance to Ofwat’s position in their 2002 merger guidance where they set out the view that “*customers could benefit from mergers if they resulted in efficiency savings or improvements in quality which are either greater or are generated more quickly than those achieved by separate entities.*”

Overall we consider Ofwat should be open to the acceleration and pace benefits that a merger can bring over the counter-factual case.

**Recommendation 5** –Ofwat should consider the potential acceleration of benefits that a merger could deliver for customers (even if it is deliverable in theory through contracted means) and consider the practicalities of contractual mechanisms proposed as counter-factuals. A balance needs to be struck between the theoretical delivery of benefits for customers through other contractual mechanisms compared to the certain delivery through a merger integration. Consider rephrasing the sentence on pg 50 to “*are a direct result of the merger (and unlikely to reasonably practically occur otherwise or within as rapid a timeframe)*”.

2.3 Balance of certainty

In the guidance there appears to be an asymmetry between the factors used to build the positive case for a merger and the counterfactual to disprove it. For example on pg 39, emphasis is placed on relevant customer benefits being eroded due to uncertain changes to the regulatory framework that may or may not happen. On the other hand, cost savings would need to be proven through post-merger integration plans over econometric modelling. Overall it gives a sense that the assessment framework is unbalanced with the presumption that a merger is not in customers interests. We would expect to see an evenly balanced merger assessment framework for Ofwat to objectively assess the benefits for customers. Our perspective is the lack of mergers since privatisation has come at a cost to customers (for example, more central support staff needed in the industry than could have been the case under a more consolidated world). These dis-benefits of not allowing mergers do not seem to feature in the assessment framework.

<b>Factors to support a merger case</b>	<b>Factors against a merger case</b>
Absolute certainty needed on cost savings that will arise (eg post merger plans over econometric models).	Pg 38 – potential changes to regulation that may or may not happen that could reduce customer benefits
Pg 33 –place lower weight on established regulatory mechanisms for clawing back benefits	Pg 38 – future abstraction reform (even if uncertain) could reduce customer benefits

Furthermore the guidance points to an expectation that benefits are sustained (pg 38). This is a hard test to prove as future regulatory models are uncertain, the effect of competition is unknown, macro factors could change, technology could impact costs and other companies could catch-up. A merger in a competitive market does not seek to create benefits that last indefinitely, but rather to create benefits that improve its competitive position. Depending on the industry, this benefit could only last a few years but be sufficient to justify a merger. The merger assessment should consider the practicality of

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demonstrating how long savings could be retained and what duration is relevant for the part of the value chain being considered.

**Recommendation 6** –Ofwat to review whether it is setting an evenly balanced assessment framework.

**Recommendation 7** –Ofwat to re-consider its interpretation of sustained benefits. As a starting point it should consider rephrasing the sentence in pg 50 to “*accrue within a reasonable period of time and are sustained*”