CONSULTATION ON OFWAT'S APPROACH TO MERGERS – SOUTH EAST WATER'S RESPONSE

JULY 2015

This paper sets out South East Water's (SEW) views in response to Ofwat's consultation on their approach to future mergers.

1 INTRODUCTION

South East Water (SEW) in its current form is the result of the merger of five former water companies in the south east of England. Under the ownership of SAUR four smaller companies were merged soon after privatisation in the 1990s. SEW in an earlier form was involved in the unsuccessful SAUR/Mid Kent/General Utilities merger referral in 1997. Most recently however it went through the post Enterprise Act merger regime with the Competition Commission (CC, one of the predecessors to the Competition and Markets Authority - CMA) in the 2006 merger of the former South East Water (fSEW) and former Mid Kent Water (fMKW).[1] We draw on these experiences in particular the MKW/SEW merger to inform the response below.

SEW is supportive of a transparent merger regime and is aware from first-hand experience of the long term benefits of mergers to customers – particularly in the areas of water resources planning and security of supplies.

The comments we have on the consultation are presented under the following headings:

- Overall comments on principles and approach
- Further clarification surrounding the proposed process;
- Further clarification surrounding 'undertakings in lieu' (UILs);

2 OVERALL COMMENTS ON PRINCIPLES AND APPROACH

Overall objective

Overall the consultation seems to be focused on making the merger process smoother once a purchase decision has been made by the relevant parties. However, we believe more work could be done to bring more certainty and clarity to the overall process pre-purchase as this could well encourage a greater number of customer-favourable mergers to take place.

Recent mergers have occurred via a referral to the Competition and Markets Authority (or Competition Commission at the time) and we believe that what this review should focus on is addressing the issue of uncertainty with the process such that potential mergers that may

[1] http://webarchive.nationalarchives.gov.uk/20121212135622/www.competition-commission.org.uk/our-work/directory-of-all-inquiries/south-east-mid-kent-water

have been considered previously, but were rejected due to the uncertainty by the purchasers, would be more likely to be pursued in the future.

We consider the two main barriers in this respect to be:

- The inability of the parties to predict the likely outcome of a referral pre-purchase
- The cost of an unsuccessful referral especially if divestment is required which will likely occur under suboptimal sale conditions

The proposals outlined in the consultation do not address these two issues as the document concentrates on a post-purchase process. The objective therefore of increasing the likelihood of customer-favourable mergers is unlikely to be realised instead what has been achieved is the potential for a shorter process. We would suggest that the length and complexity of the process is not a key barrier in comparison when compared to the two barriers mentioned above.

A key objective of any change to the merger regime should ensure that purchasers can, using Ofwat published information, accurately predict a likely outcome of the process so that they can proceed with the purchase with a better understanding of cost and risk. We do not believe the current proposals deliver this.

Providing clarity and certainty

The Cave Review 2009[2] examined the special merger regime on the basis that the current regime discouraged merger activity and that potentially there might be benefits associated with a relaxation of the regime. In order to bring about these benefits it highlighted the need for greater certainty about the process:

> *'The special merger regime represents a significant barrier to further consolidation, adversely affecting the scope for efficiency gains, financing costs and resource optimisation. I propose that the regime is reformed and restricted to those mergers which are likely to have a significant impact on Ofwat's ability to undertake comparative competition.* ***Stakeholders should also be given greater certainty about the process****.'*

The need for stakeholders to be given greater certainty about the process was made clear in the Cave Review, and our overall comments are very much focussed on this aspect.

A key objective of any merger process should be to provide greater clarity and certainty about the whole process. One significant area where this remains unclear is the pre-Phase 1 discussion between the relevant parties. We believe the level of uncertainty that remains prior to purchase under Ofwat's proposed approach remains broadly similar to the current regime and if customer-favourable mergers are to be encouraged more certainty needs to be provided.

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[2] Professor Martin Cave led an independent review of competition and innovation in water markets between March 2008 and April 2009. The Review published its final report on 22 April 2009 with recommendations to the UK and Welsh Assembly Governments and sectoral regulators (Ofwat, the Environment Agency and the Drinking Water Inspectorate). http://www.defra.gov.uk/publications/2011/12/06/cave-review/

The process described in Phase 1 does offer more certainty for parties however the lack of clarity about the pre-Phase 1 discussions may result in the most prudent assumption being made by a purchasing company that Phase 2 will be required.

We believe greater certainty can be achieved by developing and issuing an approved methodology for assessment of detriment and benefit that can be reasonably worked through and provide purchasers with a better view of the likelihood of a referral to Phase 2.

Our main concern is that the consultation as it stands only details the process and methodology requirements but doesn't make any comment on the criteria for assessing the quality of the evidence provided.

The supporting Europe Economics report[3] discusses a number of methodologies, (drawn mostly from examples within past referrals) but doesn't make reference to the assessment criteria for the acceptability of what the evidence is saying. It would give greater certainty if Ofwat were to give specific guidance on what methods and, more particularly, what quality of evidence it would find acceptable.

For increased certainty merger parties will want to know the likely costs of submitting an application and balance this with the likely outcome with the CMA. It remains difficult, even with the Europe Economics report to make an assessment of detriment and therefore offsetting benefits that could at least allow merging parties to forecast the likely referral outcome and cost.

We are concerned that in the proposed new regime, it appears that companies will need to present evidence in a way very similar to how they would do currently – but this time to Ofwat in the first instance, in an attempt to get Phase 1 only approval. The level of scrutiny proposed by Ofwat in section A1.5 'company evidence' feels at odds with a simplified process.

Ofwat seem to suggest they will evaluate the quality of the evidence, however there is no reference for assessing what the evidence shows.

We see that there is potential for the purchaser and Ofwat to almost become embroiled in a 'bidding' argument in the pre-notification and Phase 1 stage. We would like to know more detail of the ensuing process if Ofwat do not support the submission at Phase 1. It seems if you fail at Phase 1 you have to go through a very similar process of benefit assessment again with the CMA, however there is nothing provided in the consultation which gives a purchaser any likelihood of success in a full Phase 2 referral (given that Ofwat have already rejected it) – and considerably more costs. It is our view that the perceived risk to the purchaser of the Phase 1 process needs to be considerably reduced or the purchaser will have to assume that the full costs of both the Phase 1 and Phase 2 processes will be incurred. We don't believe that this is the intended outcome of the overall process.

[3] Europe Economics (2015) Valuing the Impact of Mergers and Identifying Undertakings in Lieu. http://www.ofwat.gov.uk/rpt_com201505eemergers.pdf

3 FURTHER CLARIFICATION SURROUNDING THE PROPOSED PROCESS

We would like to know more about how this early process with Ofwat and the CMA works. We found the precise details of the timing of a company submission unclear with respect to the pre-notification discussions and the beginning of Phase 1.

The document states:

> *'Prior to formally submitting a merger notification to the CMA, merger parties are **encouraged** to discuss the proposed merger with both Ofwat and the CMA.'*

For example some questions which arise are:

Pre-notification

- Is the company expected to submit their prepared application/evidence to Ofwat only for comment and indicative assessment during the pre-notification discussions – as submission to the CMA seems to trigger the start of Phase 1?
- We do not understand the mechanism for accessing the CMA during the informal pre-notification discussions – we were not aware that the CMA is structured to work in this fashion.
- What is the proposed structure at Ofwat for dealing with these requests – will there be an executive director appointed as lead for communications?
- How does Ofwat propose to fund this additional work - will there be a charge to the applicant company for the process?

Phase 1 investigation

- What is the view of conditional offers? For example, a company may offer up a significant remedy in the form of a reduction in customer bills, conditional on Phase 1 approval being obtained. If the company needed to proceed to an in depth Phase 2 reference, and incur the additional costs associated with such a reference, it may reduce the offering to customers or take this offer off the table altogether.

4 FURTHER CLARIFICATION SURROUNDING UILS

In section 5.2 of the consultation discussing UILs it refers to a previous merger case (fSEW/fMKW) where customer cost savings were implemented as a remedy. However in sections 5.3, the principles of a good UIL, and 5.4, potential types of UIL, reference is only made to 'structural' or 'behavioural' remedy undertakings, with no specific reference to customer cost savings and price reductions as a remedy. Section 5 of the Europe Economics report however includes 'price reductions' as an explicit and valid UIL for consideration.

Given their use in the recent past we are not clear as to the reason for not including 'price reductions' explicitly in section 5.4 as this seems to be an obvious remedy and benefit to customers.