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Our ref:

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Dear Tim,

CONSULTATION ON OFWAT'S APPROACH TO FUTURE MERGERS AND STATEMENT OF METHOD

We are pleased to provide our response to the guidance on the approach to future mergers and statement of methods. The consultation document was clearly laid out and it was particularly helpful that it mirrored the accompanying report by Europe Economics.

Our response follows the questions raised in the "Responding to this Consultation" section of the consultation.

Principles and Approach

We agree with the principles and approach set out in the consultation. However, we think there is benefit in being clearer on the type of benefits that can endure in the principles. We therefore suggest the following change to penultimate principle as presented:

*A merger has the potential to create customer benefits – **these may be financial and / or related to service improvement or service reliability** - which could outweigh the prejudice to our ability to make comparisons.*

Process for Phase I

Our first observation on the consultation is the scale of analysis that the statement of methods expects. It is right that the consultation puts the emphasis on the merger companies undertaking an impact assessment using the framework that Ofwat propose.

Depending on the exact nature of the merger, and how much prior notice and preparation is possible, the companies involved may have a very limited amount of time to prepare this information. The proposed approach for Phase I appears to contain the same depth of analysis that a full Phase II inquiry under the current regime involves.

Our concern is that in practice this approach will mean that it will be very challenging for mergers to be cleared at Phase I and a full in-depth inquiry will be required. This appears at odds with the intentions of government and stakeholders, that more merger clearances will be enabled by the new approach. New types of mergers and allowing existing investors to grow through equity investment in the industry through mergers benefits customers in the long run, particularly if the alternative of the status quo means that debt financed mergers and the current industry structure is locked in. Predictability as regards likely merger outcomes at Phase I is important to helping achieve these dynamic industry changes, consistent with the intentions of the Water Act 2014.

Clearly Ofwat need to consider how consumer interests are protected in this process, and we do not believe the clearance process should be accelerated and considered at Phase I if this would create a real risk of prejudice.

However, we are concerned that as currently drafted the statement of methods does not fully recognise that mergers are valid business tools to delivering customer benefits, and should have equal status to other ways that these benefits may be delivered.

We think are two aspects that Ofwat could consider to help clarify the position in line with the intentions behind the regime changes:

- in the merger principles Ofwat set out that the customer benefits can help outweigh the prejudice to the ability to make comparisons. We think that this approach should be included in the Phase I analysis by considering the weight applied to whether the merger is necessary to deliver the benefits

- another merger principle is that it is possible for Ofwat to amend regulatory approaches to reduce the impact of a loss of a comparator. It would be useful to provide examples of how this should be considered in using the statement of methods. This will emerge through actual cases, but there is a risk that this information will be less useful for mergers as the regulatory approach changes in practice. Mergers may be infrequent enough that fresh analysis is required each time (and may not be possible in the Phase I timescale) without up to date guidance on this within the statement of methods.

Statement of Methods

We welcome the clear and structured approach proposed in the statement of methods. We are mindful however that there is a risk in this approach that there could be inconsistencies in considering each area of potential prejudice to Ofwat's ability to make comparisons in isolation. An example would be where companies had atypical features. A company with a homogenous easy to serve area may appear as both efficient and with high service levels in comparisons. Whilst this is a useful indicator, a merger involving that company should not be seen as detrimental to Ofwat's ability to make comparisons, if actually a merger with a more varied entity provides better comparisons. The approach suggested by Ofwat appears to assume that such differences are useful, rather than at Phase I analysing whether they are in fact useful.

Some additional consideration of this point in the statement of methods would increase the chances that beneficial mergers will proceed at Phase I rather than requiring a full Phase II process. Although undertakings in lieu can also be proposed and accepted at Phase I, it is likely that more detail of some standard undertakings would be needed up front. Some standard licence conditions could be developed as part of a move to more modular water company licences, or recognition that the actual licence development and transfer details would need to be completed outside of the Phase I timescales. Given that this is ultimately for the CMA to accept undertakings, Ofwat's advice and process in this area is likely to have a significant impact.

One of the main challenges with the merger regime is that there is likely to be a greater disbenefit from efficient companies merging than from restructuring of inefficient companies. Given the greater dynamism that the changes in the regulatory framework for the water industry from PR14 and the Water Act 2014, we would question whether this approach will continue to best serve customers. The totex framework and outcome incentive framework should mean a greater movement in company performance – historic and static analysis is likely to become less useful, with more consideration of future company plans for innovation and efficiencies increasing in relevance.

For this reason we would also question whether the upper quartile approach for outcome delivery incentives (ODIs) can be assumed to remain for future reviews, and whether it can be used to calculate a detriment. A qualitative assessment of the value for ODIs based on considering the benefits set out in the merger case by the companies is likely to be better than a quantitative assessment, which as Europe Economics suggest would need to be treated with caution. We do not think that sufficient information on the likely change in ODI rankings and status, even where comparative assessment remains useful or useable, is likely until at least 2020.

We are happy to discuss any aspects of our response to the consultation.

Yours sincerely

Iain Vosper

Regulatory Director