

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

## Southern Water's Response



## **Southern Water's response to Ofwat's consultation on its approach to future mergers and statement of method**

### **Introduction and summary of our response**

We are pleased to provide you with our response to the consultation on Ofwat's approach to mergers.

We welcome the publication of a clear statement on Ofwat's approach and views on mergers in the sector. It is helpful, for the first time, to have a clearly set out method for assessing any detriment to the regulatory regime arising from a merger. That said, we were somewhat surprised that the tone of the consultation was not more positive about the potential benefits to customers from consolidation and restructuring within the sector. Recent Ofwat statements on the topic have certainly implied that Ofwat is open to innovative proposals for consolidation. For example Jonson Cox's recent Policy Exchange speech strongly emphasised Ofwat's interest in innovative proposals.

This sense of openness to consolidation proposals is not reflected in the tone of the document or the principles, which could have been written at any point over the last ten years and do not reflect the enormous changes in regulation that have occurred in that time. We would encourage Ofwat to look again at the principles and whether they really reflect the more limited use of comparators by Ofwat in recent years and the potential benefits from mergers.

The consultation asked in particular for comments on:

- the principles and approach to mergers
- the proposed process for Phase 1 mergers under the new Phase 1 special merger regime
- the draft statement of methods.

We provide brief comments against each of these areas below.

### **Principles and approach to mergers**

We think the clear enunciation of a set of principles for assessing a merger is very welcome. However, as we note above, we do not think that the principles, as currently drafted, reflect an appropriately balanced approach to the consideration of mergers. They do not reflect the recent greater focus on company ownership of the relationship with their customers, the increased move towards ex-post regulation and the reduced reliance on an ex-ante interventionist regulatory approach, built on comparators. We believe they should be more balanced and give greater emphasis to the potential benefits from proposals from the sector for restructuring.

We believe a number of the principles could be deleted as they are effectively a subset of the over-arching principle that "*Any merger has the potential to prejudice Ofwat's ability to make comparisons*". The repetition in successive principles of a number of forms that this potential prejudice may take gives a clear impression that Ofwat remains strongly "anti-merger" which we do not believe is the intended position.

It will also appear counter-intuitive to many readers to see that Ofwat regards a merger involving a high-performing company as particularly detrimental, without acknowledging, within the principles, the counter-argument that a high-performing company merging with a less well performing company might be expected, a priori, to increase the performance of the sector as a whole through the spread of good management practice.

We would also like to see a stronger emphasis within the principles on Ofwat actively seeking to amend the way it regulates to offset any detriment, where there are clear benefits from a merger. As currently drafted the principles say simply that “*It might be possible for us to amend our approach...*”. Where there are clear customer benefits from a merger we believe it is incumbent on Ofwat to actively seek ways to offset any detriment from the loss of a comparator so that these customer benefits can be realised and this should be reflected in the principles.

### **The proposed process for Phase 1 mergers**

The process as laid out is very clear. We agree that the 40-day period for Phase 1 consideration of a merger is extremely tight, and thus the pre-notification period will be of crucial importance. We welcome Ofwat’s commitment to engage in positive dialogue with companies in this period.

The only issue we think it would be beneficial to highlight is that any Phase 1 process must be proportionate to the likely degree of harm. That means that if there are very clear benefits and little identified harm then a detailed analysis may be disproportionate. If the process places too great a burden and expense on companies in Phase 1, then the benefits of avoiding a Phase 2 referral may be minimal and the process would not achieve its stated aim of removing the disincentive to potential beneficial mergers between undertakers. We would expect the evidential requirements for a WaSC-WaSC merger to be proportionally greater than those for a WaSC-WoC merger, reflecting the likely greater harm to the regulatory regime from the former.

### **The draft statement of methods**

We think the statement of methods provides a very clear framework against which the detriment arising from any merger can be relatively easily assessed. We have some concern about the apparent deliberate bias towards considering the maximum possible detriment while only taking account of benefits that are reasonably certain to accrue. There is also an asymmetry in the way that any detriment is assumed to persist over 30 years while any benefits will be given less weight if they are “a long way in the future, for example beyond ten years”. This asymmetry in treatment of detriment and benefits is likely to mean that very few mergers are capable of passing a Phase 1 test.

We note that in the current South West Water / Sembcorp Bournemouth Water merger case, application of the framework has identified a detriment of up to £119m, more than double the turnover of Sembcorp Bournemouth Water. We find it difficult to believe that, using the Phase 1 methodology there would have been any prospect that the relevant consumer benefits could have outweighed a detriment of this scale.

We think that it is important that Ofwat takes a balanced view in applying its assessment framework, so that any detriment identified is not wholly disproportionate to the scale of the companies concerned and that there is at least a reasonable prospect that some merger proposals could pass the Phase 1 test.