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Dear Tim

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

Sutton and East Surrey Water welcome the intention of the proposed changes to the special merger regime. Having ourselves been formed from the merger of two independent (and contiguous) licenced undertakers nearly twenty years ago, our own experience informs this response, particularly from the perspective of the benefits potentially delivered to customers through well-considered and structured mergers. We believe the potential for a merger investigation by the Competition and Markets Authority (CMA) to be completed quicker promotes beneficial mergers being brought forward. Customers can benefit from mergers through improved quality of service or increased efficiencies that may not be possible, or may take longer to realise, in the absence of a merger.

Our response is also informed by the changes in the structure of the water industry in England recently implemented and those envisaged for the next few years. At a time of more fundamental change than the industry has seen since the privatisation of the former Water Authorities in 1989, it is particularly important to define what part of the industry the special merger provisions relate to. Our understanding – and belief – is that they are designed to protect regulated activities by ensuring that there are sufficient proxies for market competition to enable the economic regulator to carry out their duty to protect customers. In particular, to make comparisons between companies to ensure that some proxies for market pressures are brought to bear on regulated businesses. It follows that the regime exists only for the sectors subject to regulation. From 2017, therefore, Retail activities for non-household customers will fall outside the scope of the regime as market forces will operate. Any merger involving only the loss of a non-household Retail comparator should therefore fall outside the scope of the provisions. Similarly, as upstream competition becomes more widespread, areas no longer needing to be regulated will fall outside the scope of the protections afforded by these provisions. This clarification is important to avoid the provisions now being put in place having to be revisited in the foreseeable future.

Clear guidance on what evidence the merging companies need to provide should further reduce barriers by creating certainty in how the evidence will be assessed. We feel that the draft statement of methods sets a high hurdle for companies to meet in terms of the evidence and analysis they must present for a merger to be accepted at Phase 1. We accept that the onus should be on the companies to demonstrate customer benefits but below we ask for clarity on

some of the evidence required and the timescales allowed.

Principles and approach to mergers

We support the onus being on merging companies to demonstrate the overall benefit of the merger and that the focus should be on demonstrating the relevant customer benefits. We agree that this evidence needs to demonstrate clearly and robustly that customers will benefit and that these benefits should, where possible, be quantified.

We also agree that the merging companies should consider the impact on Ofwat's ability to make comparisons. Putting a value on this assessment will be more challenging – it is difficult to quantify the impact of losing a comparator. What is however evident is that there are a range of approaches that could be taken and there will be no right answer. For this reason we suggest below that more time may be needed to consider fully the merger impact assessment submitted by the companies.

The complexity of considering the impact on Ofwat's ability to make comparisons may in turn impact on the merging companies' abilities to propose suitable undertakings in lieu (UILs) in their merger notice. We therefore support the inclusion of a second opportunity to propose UILs following publication of the CMA notice of decision and Ofwat's analysis. This will allow companies to consider what further UILs may be suitable once they have all information available to them.

We do not agree with the principle that the merger of a high performing company could prejudice your ability to set cross industry benchmarks. We provide our views on this below in our comments on your draft statement of methods.

Proposed process for Phase 1 mergers under the new special merger regime

We support the three stage approach outlined for Phase 1 of a merger investigation. Clarification on whether the merger impact assessment is published on day one would be helpful.

We have some concerns that the timelines for the second stage, the Phase 1 investigation, are tight. There will be detailed and invariably complex analysis submitted in the merger impact assessment. 15 working days may not provide sufficient time for Ofwat to be able to take a measured view on the quality and robustness of the analysis and the results produced.

A solution that provides flexibility to introduce additional time upfront to make sure all parties have had a chance to consider and question the evidence is preferable to facing the risk that mergers may unnecessarily go to Phase 2. To rectify this we suggest that timelines should allow for an extension to the initial stage of Phase 1 should Ofwat need additional time to replicate the analysis presented in the merger impact assessment.

To remove uncertainty around the timescales we would like to see their inclusion as statutory deadlines on the CMA. We welcome clarification from you on the process for introducing the secondary legislation needed to do this.

Draft statement of methods

You quite rightly put the onus on merging companies to evidence the net benefits of the proposed merger. The statement of methods helpfully provides guidance on what information you will be looking for and how you expect it to be presented and assured. For some of the criteria for determining whether the merger would prejudice your ability to make comparisons we feel that they narrow the scope of the evidence that companies could provide. We would appreciate commitment that all potential scenarios can be considered reasonable if they can be justified.

The loss of an independent comparator

We do not agree that a merger reduces the value of receiving and using separate information on each company in the merger to the point where it is no longer worthwhile to collect as suggested in your consultation. The information would not be independent if management structures are aligned but it could still add value to econometric models and other forms of comparative assessment. We think that agreement to continue separate reporting following a merger should be considered as a means of mitigating the loss of a fully independent comparator.

It may also have advantages for benchmarking. It is reasonable to expect that a leading company that merges with a poorer performer will drive up performance in the poorer performer. If this was the case including both companies in benchmarking analysis would push the frontier higher at the next price control.

The extent of change to benchmarks

We think that the impact on benchmarks is not as clear cut as you suggest. For example, a leading company that merges would have to perform worse under the merger for it to be detrimental to customers. This is one scenario but it seems equally likely that the leading performer would stay as the leading performer, and potentially find further efficiencies post-merger. It would be up to the merging companies to justify this.

Loss of a comparator with important similarities

The example provided under this criterion is the potential detriment from contiguous companies merging as they may be operating under similar circumstance. We would expect you to also consider the benefits of increased resilience that merging contiguous companies could bring. The increased resilience from integration of networks and the broader access to water resources and treatment capacity has been one of the principal benefits for customers of the merger of Sutton and District Water with East Surrey Water. This has not been manifest overnight – indeed the benefits are still being delivered as the combined company continues to invest in the enhanced treatment capacity (in AMP5) and the enhanced network inter-connectivity (in AMP5 and for the next ten years) that delivers improved resilience. Whilst this may only deliver benefits (in terms of water restrictions avoided) on an infrequent basis, our extensive customer research for the PR14 Price Review demonstrated that this was nevertheless a benefit valued by customers. It should therefore be considered carefully in any future merger proposals.

Concluding remarks

We support the intent of the changes but have some concerns that, as drafted, the guidance may result in some of the benefits of any merger being overlooked. We agree that it should be up to the merging companies to demonstrate the benefits. We have made suggestions above where we think the criteria can be modified to leave it open for companies to provide such evidence.

As always, we would be more than happy to further explain any aspect of our response. In the first instance please get in touch with Joanna Campbell, Economic Regulation Manager (JoannaC@waterplc.com, 01737 785 692).

Yours sincerely

John Chadwick
Finance and Regulation Director