



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

Consumer Council for Water Response

July 2015

1. Introduction

- 1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales.
- 1.2 We welcome the opportunity to comment on Ofwat's consultation on its proposed principles and approach to assessing future mergers, which considers Ofwat's greater role in the special mergers regime and changes to the process that will be introduced once the relevant sections of the Water Act 2014 are commenced by the Secretary of State.

2. Executive Summary

- 2.1 We are broadly supportive of the proposed new special merger regime as it could remove the need for expensive in-depth investigations of potential water company mergers. It could also considerably reduce the time between pre-notification and clearance of the merger, allowing for customer benefits such as reduced prices and improvements to service quality to be delivered earlier than at present.
- 2.2 However, our support for water company mergers is conditional upon any detriment to the regulatory system and to consumers being remedied by measurable benefits for consumers.
- 2.3 Detriment to the regulatory regime could be caused by a reduction in the precision of the comparative tools used by Ofwat to incentivise performance. This could cover the efficiency challenges that Ofwat makes at each price review or its comparative assessment of companies' performance against the Service Incentive Mechanism and operational performance measures, including Outcome Delivery Incentives. In each case, the detriment to the regulatory system would also impact on customers.
- 2.4 Further detriment to customers could be caused if the merging companies were allowed to merge datasets at the outset. This would weaken the level of scrutiny that Ofwat, CCWater (and other parties) would be able to make of the operational and customer service performance of the two constituent parts of the merged entity. This could be particularly unfortunate if the merging companies were at opposite ends of the performance spectrum, with the potential for the merged data to mask deteriorating (or improving) performance in one of the constituent companies.
- 2.5 We agree that customers' views should play an important role in Ofwat's assessment of any merger. We are, therefore, concerned that Ofwat has chosen not to seek directly the views of the statutory customer representative body as it prepares its draft opinion to the Competition and Markets Authority (CMA) or for the issues meeting with the CMA.
- 2.6 We believe that CCWater should have the opportunity to make a case to Ofwat on behalf of customers, ahead of any formal Phase 1 investigation, and that this is reflected in the submission to the CMA. We do not think it appropriate for Ofwat to rely on the companies engaged in the merger to provide the customer view. The

customers of the company may lack the comparative picture and may be persuaded too easily by the company's argument.

- 2.7 We also question whether there is sufficient time between the acquisition of a company and the start of a Phase 1 investigation for companies to carry out robust customer research that involves customer representative groups in its design, analysis and interpretation. It is important, for all concerned, that the research process and methodology is reliable and yields findings which accurately and fairly represent customers' views.

3. Response to the consultation

- 3.1 When the relevant sections are commenced by the Secretary of State, the Water Act 2014 will introduce a two phase process to the special mergers regime. Ofwat will have a greater role during the first phase (Phase 1) of a merger inquiry under the new regime before the CMA undertakes a potentially shortened Phase 2 investigation.
- 3.2 The consultation seeks responses in particular on Ofwat's
- principles and approach to mergers;
 - proposed process for mergers under the new Phase 1 special merger regime; and
 - draft statement of methods.

Ofwat's principles for assessing mergers

- 3.3 We generally agree with Ofwat's high level principles for assessing mergers, and in particular, the principle of whether any merger has the potential to impact Ofwat's ability to make comparisons.
- 3.4 CCWater supports water company mergers in principle with our support for specific mergers resting on the merits of the individual case. However, our support for water company mergers is conditional upon any detriment to the regulatory system and to consumers being remedied by measurable benefits for consumers.

Ofwat's proposed process for Phase 1 mergers under the new Phase 1 special merger regime

Streamlining the process

- 3.5 We support the proposed new special merger regime as it could remove expensive in-depth investigations of potential water company mergers. It could also considerably reduce the time between pre-notification and clearance of the merger; allowing for customer benefits such as reduced prices and improvements to service quality to be delivered even earlier than at present. Under the new regime the CMA will have up to 40 working days from receipt of a complete merger notice to conduct the Phase 1 investigation. In this phase, in addition to existing tests on applicability and turnover, the CMA can decide not to refer a qualifying water merger to a six month inquiry group-led investigation (Phase 2).
- 3.6 We support, in principle, Ofwat's proposed process for Phase 1 mergers under the new Phase 1 special merger regime. This is because it places emphasis on the

merged parties to provide sufficient evidence and a robust and thorough analysis to justify why the merger should not proceed to Phase 2; including an assessment of relevant customer benefits and that these benefits accrue within a reasonable period of time and are sustained.

- 3.7 We note Ofwat's approach to licence modifications, and that Ofwat may seek changes even if merged parties do not ask for a single licence. Updated licences would include the introduction of the full suite of ring-fencing, a requirement that prices in the acquired area are no higher than they otherwise would have been under the current price control, and any provisions which would ensure that the customers of the acquired company do not receive deterioration in service which we welcome.
- 3.8 We believe it is important the merger of two companies does not result in detriment to customers as a consequence of Ofwat's ability to compare companies being diminished. This could happen if the merger were to reduce the level of scrutiny that Ofwat (and other parties) would be able to make of the operational and customer service performance of the two constituent parts of the merged entity.

Seeking customers' views

- 3.9 We agree that customers' views should play an important role in Ofwat's assessment of any merger. Companies will be expected to submit evidence which suggests that customers support the proposed merger or the proposed benefits from the merger. We expect companies to carry out robust and representative customer research, involving CCWater and their Customer Challenge Groups.
- 3.10 We are, therefore, concerned that there is no mention in the consultation of Ofwat requesting the view of the statutory customer representative body as it prepares its draft opinion to the CMA, or for the issues meeting with the CMA. We note the consultation states that Ofwat will continue to engage with and request information from merger parties as appropriate until it makes its final submission to the CMA.
- 3.11 Water companies in England and Wales voluntarily provide CCWater with information about their customer service and operational performance on a quarterly basis. As a consumer body we consider it appropriate to make the information we hold about the performance of water companies available to consumers and other interested parties, and we do so through publication of our annual '*Delving into Water*' report¹.
- 3.12 Benchmarking performance can inform CCWater's and stakeholders' challenges to companies, leading to benefits for customers. We use the comparative information in this report to continue to push poorer performing companies to improve their performance by adopting industry best practice, where appropriate, or by developing innovative solutions to issues and service problems that customers view as important. We also monitor the performance of the better performing companies to ensure that their service levels to customers do not deteriorate and, indeed, continue to improve.

¹ 'Delving into Water' - Performance of the water companies in England and Wales 2010-11 to 2013-14
<http://www.ccwater.org.uk/wp-content/uploads/2015/01/Company-performance-report.pdf>

3.13 We acknowledge that CCWater will be able to input into the process when the CMA publishes an invitation to comment notice in order to understand third parties' views on the merger on Day 1 of the Phase 1 investigation. However, we consider that CCWater should have the opportunity to make a case to Ofwat on behalf of customers ahead of a formal Phase 1 investigation. We believe that CCWater should have the opportunity to highlight any potential detriment to the regulatory system and to customers from a proposed merger, putting forward evidence of companies' performance to give context, and that this is reflected in Ofwat's submission to the CMA. We do not think it appropriate for Ofwat to rely on the companies engaged in the merger to provide the customer view. The customers of the company may lack the comparative picture and may be persuaded too easily by the company's argument.

Loss of comparators

3.14 We believe that detriment to the regulatory regime and customers may occur if a merger is allowed to proceed without putting in place appropriate remedies. This could happen if the merger were to reduce the level of scrutiny that Ofwat (and other parties) would be able to make of the operational and customer service performance of the two constituent parts of the merged entity.

3.15 Detriment to the regulatory system, and therefore customers, could be caused by a reduction in the precision of the comparative tools used by Ofwat to incentivise performance. For example, during the Price Review 2014 (PR14) Ofwat concluded that, for wholesale cost benchmarks, a merger of two companies might result in an altered efficiency challenge which could disbenefit customers.

3.16 Furthermore, there is the potential for successive water sector mergers to weaken Ofwat's efficiency challenge by reducing the number of comparators. Over time this could reduce the incentive on companies to drive operational and service improvements to the disbenefit of customers more generally.

3.17 We believe there is a bigger risk of water only companies (WoCs), particularly high performing WoCs, being merged with larger water and sewerage companies (WaSC). As the number of WoCs decline, not only is there likely detriment to Ofwat's comparative regime for the industry as a whole, but also between individual WoCs.

3.18 Similarly, reducing the number of comparators for the Service Incentive Mechanism (SIM) measure - especially if one of the comparators was a leading company - could lead to a convergence of scores and increase the 'noise' around the data. This would have two potential effects:

- middle ranking companies being given a SIM reward greater than they would otherwise have received had the leading company been included within the comparative analysis; and
- a consequent reduction in the ambition of companies to continue to innovate and drive up performance.

3.19 We acknowledge that a merger has the potential to create customer benefits which could offset the impact to Ofwat's ability to make comparisons. However, we believe an appropriate balance needs to be struck between opportunities for cost savings (and possibly lower prices) and service quality. For example, centralising

functions such as contact/call centres would be expected to save on operational costs, but this should not be at the expense of service quality. Combining the call centres of a top performing WoC with a poorer performing WaSC could impact on the merged company's performance in handling contacts from customers. We would not want to see the level of service quality experienced by customers deteriorate following a merger.

- 3.20 We agree that Undertakings in Lieu (UILs) may be appropriate to remedy, mitigate or prevent a prejudice to Ofwat's ability to make comparisons. The consultation gives the example of the remedies in the South East/Mid Kent merger of a one off rebate of £4 million distributed between customers and an efficiency adjustment of £3.1 million annual operational expenditure savings required as part of the 2009 Price Review. But there was no explicit requirement on the merged company to maintain service levels. The performance levels of the merged entity deteriorated in the immediate post-merger period.
- 3.21 We consider that there should be undertakings to maintain or improve service levels backed up by both, or either of, the SIM and Outcome Delivery Incentive frameworks and, where appropriate, by additional sanctions.

Ofwat's draft statement of methods

- 3.22 We agree with the criteria proposed for determining whether the merger would affect Ofwat's ability to make comparisons. We firmly believe there needs to be sufficient companies to facilitate effective comparison otherwise it will reduce the scale of challenge for the sector as a whole, impacting on Ofwat's setting of price limits (cost benchmarks / total expenditure), challenging for improved service quality and sharing best practice for example.
- 3.23 We support the criteria for assessing relevant customer benefits as this will go some way to ensuring customer protection. As noted above, we support the criteria for company evidence, particularly the requirement on companies to provide evidence that customers support the proposed merger or the proposed benefits from the merger.
- 3.24 However, given the short timescale between acquisition of a water company and the start of a Phase 1 merger investigation, we question whether this offers sufficient time for companies to carry out robust customer research that involves customer representative groups in its design, analysis and interpretation. It is important that there is sound governance of the research process and that the research methodology is reliable and yields findings which accurately and fairly represent customers' views. Customer research should, therefore, be conducted by a reputable research agency, in consultation with CCWater and the Customer Challenge Group to ensure, amongst other things, that the research is not leading or misleading.

Enquiries

Enquiries about this consultation response and requests for further information should be addressed to:

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