

About this document

This document consults on our proposed approach to mergers under the new special merger regime which was introduced as part of the Water Act 2014. It also consults on our draft statement of methods for mergers.

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Overview

A water merger occurs where two or more water companies¹ cease to be distinct by coming under common ownership or control. As each water company is a regional monopoly, we use comparative information to ensure that customers are paying a fair price for their water, to identify good performance and to set incentives for companies to improve. This need for comparative information is recognised through a special merger regime which examines whether water sector mergers may prejudice our ability to carry out our functions by impacting on our ability to make comparisons.

The Water Act 2014 makes changes to the special water merger regime. This new regime introduces a two stage process to water mergers which aims to reduce the disincentives for companies to merge and the level of regulatory uncertainty when a merger is proposed. The new regime provides a greater role for the Water Services Regulation Authority (Ofwat) during the first stage (Phase 1) of a merger inquiry and will require us to provide an opinion to the Competition and Markets Authority (CMA) on: the impact of a merger on our ability to make comparisons and relevant customer benefits; and whether undertakings in lieu (UILs) would remedy, mitigate or prevent the prejudicial effect on our ability to make comparisons. The changes made by the Water Act 2014 also require Ofwat to consult on and prepare a statement of methods, which sets out the criteria we will use to assess the impact on our ability to make comparisons and the weighting applied to those criteria². **This document consults on our proposed approach to mergers under the new special merger regime and our draft statement of methods.**

Water Act 2014 amendments to the special merger regime

When the relevant sections are commenced by the Secretary of State, the Water Act 2014 will introduce a new Phase 1 process to the special mergers regime. In the new Phase 1 process, in addition to the 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 if:

- the merger is not likely to prejudice Ofwat's ability to make comparisons;
- the likely prejudice is outweighed by relevant customer benefits; or

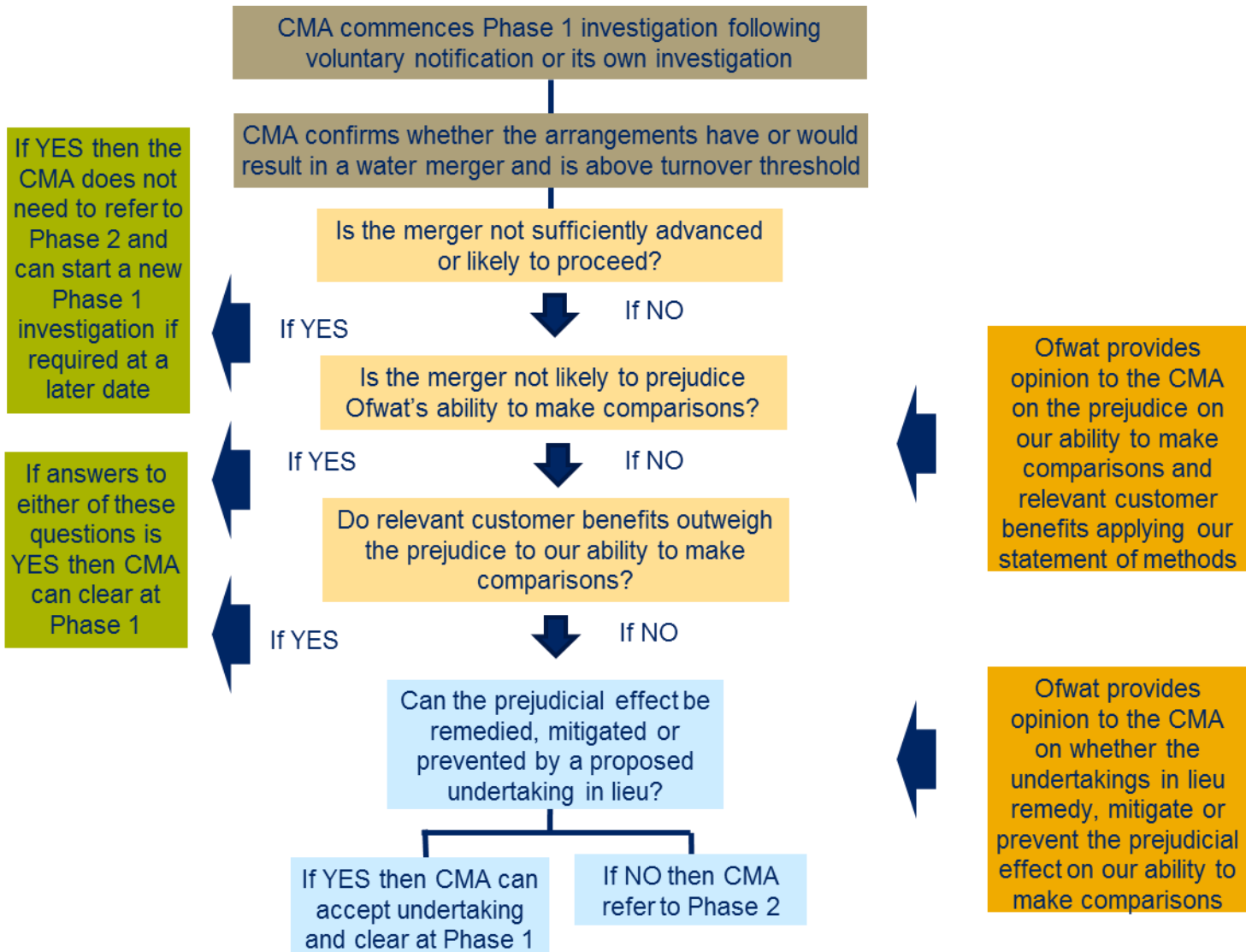
¹ We use the term "water companies" to mean companies holding appointments as water and/or sewerage undertakers under Chapter 1 of Part 2 of the Water Industry Act 1991.

² See section 33C of the Water Industry Act 1991 (inserted by section 14(2) of the Water Act 2014).

- the company has offered appropriate UILs of a reference which remedy, mitigate or prevent the prejudicial effect on our ability to make comparisons.

The Water Act 2014 does not affect the Phase 2 merger process. Figure 1 sets out the Phase 1 process and our role when the Water Act 2014 changes are brought into force.

Figure 1: Phase 1 merger process following the Water Act 2014



Why comparisons are important

Under the new regime, before deciding on whether to refer a merger to a Phase 2 inquiry, the CMA will consider whether a merger is likely to prejudice our ability to

make comparisons. We are required to provide an opinion to the CMA on whether and to what extent we consider this is the case.

Water companies are regional monopolies, so comparisons between water companies have underpinned the way we have regulated the sector since privatisation. We make use of comparisons both during the price review process, for example in setting price limits or service quality requirements, and between price reviews, for monitoring and enforcement and spreading best practice. While our approach to making comparisons has changed over time, without the ability to make comparisons between water companies then it is likely that we would not have been able to set the same stretching cost and service targets. This, in turn, would have been a detriment to customers through higher bills or lower service quality.

Particular areas where we have recently made use of comparisons include:

- wholesale and retail cost modelling in the 2014 price review where we used information on individual water company costs to develop our cost models, cost benchmarks and cost allowances;
- outcome delivery incentives (ODIs) which were set at the 2014 price review where, for five cross-company ODIs we used comparisons across water companies to identify upper quartile performance and intervened to ensure that companies were only able to access financial rewards for genuinely stretching performance;
- service incentive mechanism (SIM) which uses qualitative and quantitative measures of customer satisfaction to financially reward or penalise companies based on their performance relative to the rest of the industry; and
- standards of board leadership, transparency and governance across companies where we highlighted and shared best practice to encourage all companies to meet our principles in this area.

The 2014 price review introduced changes to the way that we regulate, for example the setting of separate price limits for wholesale and retail elements. The way we regulate is likely to change further going forwards, for example the introduction of competition into non-household retail and the creation of separate price controls in new areas. While this is likely to reduce the importance of direct comparisons between water companies in some areas, for example retail, there are other areas which will still be regional monopolies, such as companies' water and wastewater networks, where we will still need to make use of comparisons. If we set price limits at a more granular level it is also possible that our use of comparisons in some of these areas might become more important.

Our principles for assessing mergers

We have developed a set of high level principles which will guide our approach to mergers.

- Each merger will be considered on its merits, taking full account of its benefits.
- Any merger has the potential to prejudice Ofwat's ability to make comparisons.
- A merger between companies whose scope of activities does not overlap is unlikely to prejudice our ability to make comparisons.
- A merger of a high performing company in terms of efficiency/service could prejudice our ability to set cross industry benchmarks.
- Each merger may permanently reduce the number of independent comparators in the monopoly parts of the value chain; and as a result the detriment to the comparative regime may increase for each successive merger.
- A merger could lead to the loss of a company which had important similarities to other companies, for example operating in similar conditions facing similar issues.
- A merger could lead to the loss of a company which had important differences from other companies, which for example could reduce the scope of the development of best practice.
- It might be possible for us to amend our approach to offset, to an extent, the impact of the loss of a comparator;
- A merger has the potential to create customer benefits which could outweigh the prejudice to our ability to make comparisons.
- UILs may be appropriate to remedy, mitigate or prevent the prejudicial effect on our ability to make comparisons.

What benefits could a merger bring?

Under the new regime, the CMA does not need to refer a merger to a Phase 2 investigation if relevant customer benefits from the merger outweigh the likely prejudice to our ability to make comparisons. We are required to provide our opinion to the CMA on whether relevant customer benefits outweigh the prejudice to our ability to make comparisons.

Relevant customer benefits can take the form of:

- lower prices, which could result from operational cost savings (reduced head office costs), improved water resource management (from contiguous

companies sharing/better planning of resources) or reduced financing costs (from the ability of a larger company to obtain more favourable terms);

- higher service quality, for example by improving security of supply;
- greater choice, for example through the greater availability of special tariffs; and
- greater innovation, for example through greater effectiveness of research and development or the creation of innovative new structures from the merger itself, for example a very large water only company or a wastewater only company.

Relevant customer benefits can only be considered if they would be unlikely to be realised without the merger or a similar prejudice to our ability to make comparisons.

Undertakings in lieu

Under the new regime, the CMA may accept undertakings in lieu of making a reference for a Phase 2 inquiry. The CMA will consider whether the proposed undertakings would remedy, mitigate or prevent the prejudicial effect of the merger on our ability to make comparisons. We are required to provide our opinion to the CMA on the effect of the proposed undertakings, including the extent to which they would remedy, mitigate or prevent the prejudicial effect.

Our advice to the CMA on whether a UIL is acceptable will depend on the circumstances involved and the level of prejudice created. When assessing potential UILs we will consider the prejudice to our ability to make comparison now, but also what measures might assist our ability to make comparisons in the future. When considering UILs, we will be particularly concerned about the degree of independence of any new comparators that might be created. For example, we would have a preference for ownership independence over management independence, and for accounting separation over separate reporting.

In Phase 1 of a merger investigation, we will want to be confident that the likely prejudice will be resolved by the UILs offered without the need for Phase 2 investigation. We consider that UILs are only appropriate where there are clear cut remedies proposed to address the prejudice caused by the merger. This mirrors the CMA's approach to UILs in the general merger regime. We would not expect that every merger will be resolved at Phase 1. It should be emphasised that the final decision to accept UILs rests with the CMA, after considering Ofwat's opinion.

UILs could include:

- divestiture, for example the sale of a non-contiguous part of the water company, which could create an additional independent comparator;
- partial divestitures, for example a reduction in the equity stake and therefore the degree of control, which in some circumstances, could create management independence and restore our ability to make comparisons;
- separate administration, for example an undertaking to maintain or create separate management, accounting or reporting arrangements, for either the company taken over or for particular services within the merged entity. This could include, for example, offering to create a separate retail company, or separate management of water resources and networks; and/or
- amending licences, for example the creation of modular licences for separate services within the merged entity.

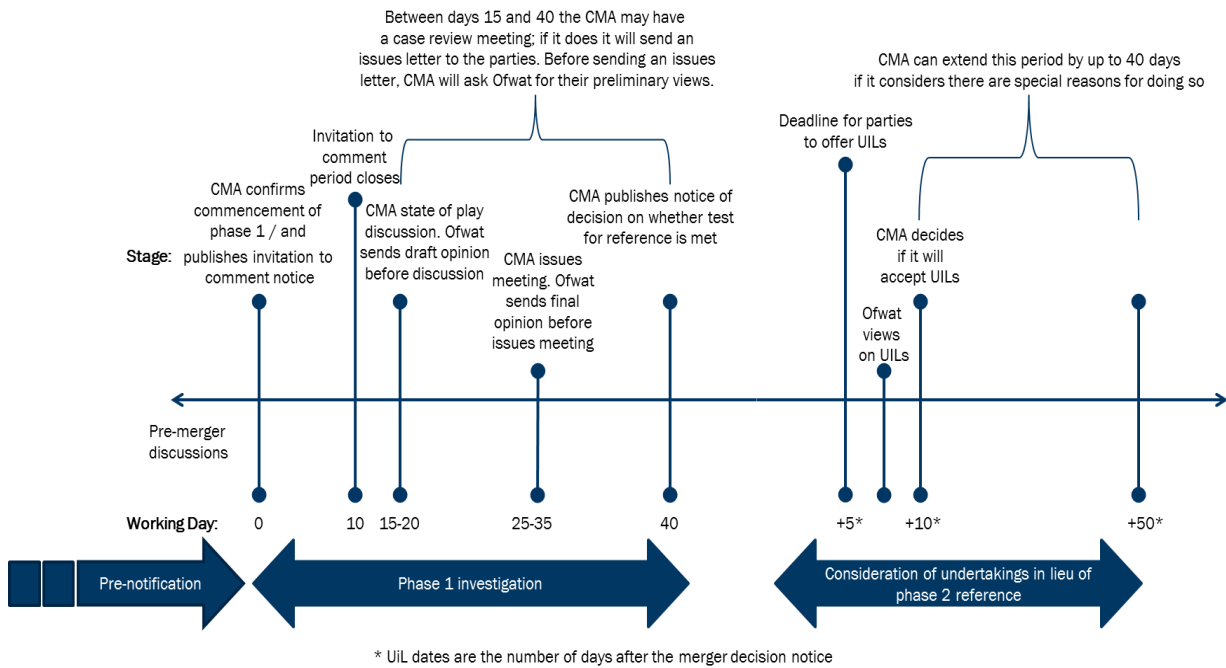
The Phase 1 process and our expectations of merger parties

The Water Act 2014 does not specify a timetable for water mergers. If the CMA's general merger regime timetable is applied to Phase 1 water mergers, and taking into account the statutory requirements, there are up to three main stages to the Phase 1 process, as shown in Figure 2:

- **Pre-notification:** during pre-notification merger parties will need to develop a merger impact assessment, which will set out the expected impact of the merger. In undertaking the merger impact assessment merger parties should have regard to our statement of methods which sets out how we will assess mergers. 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. There is no formal time limit on these discussions, so merger parties are encouraged to open dialogue with Ofwat and the CMA at the earliest opportunity to enable all parties to consider their positions ahead of any formal Phase 1 investigation.
- **Phase 1 investigation:** the CMA will have up to 40 working days from the receipt of a complete merger notice to conduct the Phase 1 investigation. During this period the CMA will consider whether the merger will prejudice Ofwat's ability to make comparisons and where relevant, whether customer benefits arising from the merger would outweigh this prejudice. The CMA must request and consider Ofwat's opinion on these issues within this time period. Ofwat must provide its advice in accordance with its statement of methods. If merger parties have raised UILs by this stage of the process, the CMA must also consider Ofwat's opinion on the effect of those UILs.
- **Consideration of UILs of a phase 2 reference:** if the CMA concludes that a merger prejudices Ofwat's ability to make comparisons between water companies and that this prejudice is not outweighed by relevant customer

benefits, the merger parties will have the opportunity to propose UILs to offset that prejudice. If UILs are proposed the CMA must request and consider Ofwat's opinion on these undertakings before determining whether the UILs offered are sufficient to offset the prejudice.

Figure 2: Potential timings for Phase 1



One of Parliament's objectives of the new regime is to reduce the number of mergers being referred to an in-depth Phase 2 investigation as these investigations were viewed as a disincentive to potentially beneficial mergers. The short timescales for the formal Phase 1 investigation places importance on the quality of the evidence provided by merger parties during the pre-notification and Phase 1 process.

Consistent with our strategy of companies taking responsibility for the relationships with their customers, we expect merger parties to have a good understanding of the potential impact of the merger, particularly in terms of relevant customer benefits. We expect companies to set out in their merger impact assessment submission (submitted at the start of the Phase 1 process), their views on:

- the impact of the merger on our ability to make comparisons;
- the relevant customer benefits that arise directly from the merger, and whether these outweigh the impact on our ability to make comparisons; and, if they do not,
- any ULs that would prevent, mitigate or remedy the prejudicial effect on our ability to make comparisons.

To provide the best opportunity of us recommending to the CMA that the merger is cleared at Phase 1, merger parties should develop their submission in line with our statement of methods and take account of the report that we have commissioned into valuation methods by Europe Economics³. As set out above, due to the short timetable in Phase 1 and the importance of the merger impact assessment submission, merger parties are encouraged to discuss their proposed submission with us during the pre-notification phase of the process.

Our statement of methods

Our statement of methods is required to set out the criteria and the weighting of those criteria we will use to assess whether a merger is likely to prejudice our ability to make comparisons, and whether relevant customer benefits outweigh that prejudice. Our criteria are based on:

- our statutory duties;
- our principles for assessing mergers;
- the requirements of the new regime introduced by the Water Act 2014; and
- the approach taken by the Competition Commission and Ofwat in previous merger cases.

The assessment of the impact of a merger will be based on evidence provided by merger parties, where appropriate taking into account our own analysis. The assessment will be based on a comparison between the factual (with merger) and counterfactual (without merger) situation. We will also use a scenario-based approach to take into account future uncertainty. This approach will include potential changes to regulatory policy, based on public statements about where and how our approach might change. Further, we will consider the loss of a comparator in each of the areas where we use comparisons: setting price limits, service quality and our ongoing role in monitoring, enforcement and spreading best practice.

Our criteria for assessing whether a merger would prejudice our ability to make comparisons are:

- the extent to which the merger involves overlaps in functions – if it does not then we will take the view that there is no prejudice e.g. a water only company taking over sewerage functions would not prejudice our ability to make comparisons in these areas;

³ Europe Economics (2015) Valuing the Impact of Mergers and Identifying Undertakings in Lieu. This document can be accessed at: http://www.ofwat.gov.uk/rpt_com201505eemergers.pdf

- whether the merger involves the loss of an independent comparator – if it does not then we will take the view that there is no prejudice e.g. if the company taken over is already not distinct (for example there is already cross ownership and control) then our ability to make comparisons would not be prejudiced;
- the extent to which the merger would change benchmarks – our ability to make comparisons is likely to be more affected if we were to lose a high performing company as this could change cross-industry benchmarks and reduce the efficiency challenge for all companies;
- the number and quality of independent comparators that remain – for example, during the 2014 price review (PR14) we developed robust cost models for water with 18 comparators, however, the models for wastewater proved more difficult to develop where we only had 10 comparators meaning we are likely to be more concerned with losing a wastewater comparator;
- a loss of a comparator with important similarities for comparisons – our ability to make comparisons is likely to be more affected if we lost a company which had important similarities to a small number of the remaining companies. For example, if we lost a company with high population density it might be more difficult to separate out the impact of this factor driving cost and outcome performance;
- a loss of a comparator with important differences for comparisons – for example, best practice in terms of customer engagement, or a company which had a good track record of innovation that could be used to raise standards across the sector; and
- are there alternative approaches available to us to offset the loss of this comparator? – that is, could we amend our regulatory approach to offset the loss of this comparator?

The assessment of the first two criteria will be based on yes/no response, although we accept that this can sometimes be a matter of degree. If the answer to either question is no, then we are unlikely to take the view that the merger would cause prejudice to our ability to make comparisons. If this is the case then we would not proceed with the assessment against the other criteria and would provide our opinion to the CMA on that basis.

We will apply equal weights to each of the other criteria. Where possible we will monetise impacts against these criteria, that is convert impacts into a £m impact. This will identify the scale of impact and the relative weight of that impact against other criteria. We will take account of the impact over time by discounting future values to present values. We will calculate the present value both over 30 years (to reflect the long term impact of the loss of a comparator) and 5 to 10 years (where impacts are more certain).

Where monetisation is not possible, we will undertake a quantitative or qualitative assessment of the impact on our ability to make comparisons and indicate the severity of the impact. When assessing impacts we will take into account the certainty around whether the impacts would occur, for example through changes in regulation, for example by including ranges around impacts.

In preparing our opinion we will bring together the monetised, quantitative and qualitative impacts. After summing all monetised impacts, we will consider whether, in the round, the non-monetised impacts would change the balance of the decision and whether the overall impact constituted a prejudice to our ability to make comparisons.

The criteria for relevant customer benefits will be based on the legislation, as follows.

- Are there relevant customer benefits? These must be in terms of lower prices, higher quality or greater choice of services or greater innovation in relation to such services and must accrue to customers of merger parties.
- How likely or certain are the benefits to be achieved?
- Are the benefits merger specific? The benefits must be a direct result of the merger (and unlikely to occur otherwise).
- Are benefits likely to accrue in a reasonable period of time?
- Are benefits likely to be sustained?

As with the impacts on comparators, we will weight impacts against the criteria based on their monetised impacts. Where monetisation is not possible we will consider non-monetised impacts. We will attach most weight to customer benefits which are certain.

When determining whether the prejudice is outweighed by relevant customer benefits we will consider both monetised and non-monetised impacts. When undertaking this assessment we will be conscious that, there is the potential for a Phase 2 investigation. We will therefore need compelling evidence to recommend to the CMA that in our view customer benefits outweigh the likely prejudice from the impact of the merger on our ability to make comparisons. When undertaking this assessment we will be mindful that merger-specific relevant customer benefits might be short lived as they could be eroded by non-merger specific efficiency improvements (such as via the regulatory process).

When assessing evidence provided by parties on the impact on our use of comparators and relevant customer benefits, we will use the following criteria.

- Clarity and transparency around the approach and assumptions;

- Completeness of the description of the analysis;
- Ability of Ofwat to replicate results;
- Robustness and independent assurance; and
- Evidence of customer support.

In assessing the impacts of the merger on our ability to make comparisons and the customer benefits, the greatest weight will be placed on merger party assessments which are complete, robust, certain, clear, independently assured and which provide evidence of customer support.

Next steps

We are consulting on our draft statement of methods for six weeks. We would welcome consultation responses on any part of this document including our approach to mergers and our draft statement of methods. In particular we would welcome responses on:

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

When providing responses stakeholders should be mindful of the requirements of the new special merger regime and our statutory duties.

Our next steps are:

Date	Action
29 May	Consultation on Ofwat's approach to mergers and draft statement of methods
10 July	Consultation closes
September	Ofwat publishes approach to mergers and final statement of methods

Structure of the rest of this document

The rest of this document is structured as follows:

- Chapter 1: sets out the legal background to the new special mergers regime;
- Chapter 2: sets out why water sector comparisons are important for the regulation of water companies;
- Chapter 3: sets out our principles for assessing mergers;

- Chapter 4: sets out the potential benefits that a merger could bring;
- Chapter 5: sets out potential undertakings that might be acceptable in lieu of a Phase 2 merger reference;
- Chapter 6: sets out the Phase 1 process in the new special merger regime and our expectations of merger parties;
- Appendix 1: sets out our draft statement of methods;
- Appendix 2: provides background to our assessment of mergers and gives examples of how we use comparators and highlights relevant customer benefits and undertakings and remedies in previous water merger cases; and

Responding to this consultation

Responding to this consultation

We invite comments on the proposals in this document by 10 July 2015. We would welcome consultation response on any part of this document including our approach to mergers and our draft statement of methods. In particular we would welcome responses on:

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

You can e-mail your responses to mergers@ofwat.gsi.gov.uk or post them to:

Mergers
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Tim Griffiths on 0121 644 7610 in the first instance.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory 'Code of Practice' which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take

full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. The new special merger regime

1.1 Why is there a special merger regime for the water sector?

The water sector in England and Wales comprises 18 incumbent regional monopoly companies, including 10 water and sewerage companies with between 1.2 million and 8.5 million customers each and 8 main water only companies with between 0.1 and 3.1 million customers each. There are also 6 small water companies with around 2000 customers each providing either water or sewerage services or both and more than 10 water supply licensees offering water services to large use customers. The 18 main incumbent water companies and 6 small water companies are all subject to the special merger regime.

A merger occurs when enterprises will cease, or have ceased, to be distinct because they come under common ownership or common control.⁴ The special merger regime applies when two or more water companies merge with each other.⁵ The special merger regime does not apply to water supply licensees, but it will cover a retail business carried on by a water company when two or more water companies merge. Mergers between water supply licensees (or between a water company and a water supply licensee) are covered by the general merger regime.⁶ Where a water company merges with another business outside of the industry it is known as a change in ownership and these mergers are not subject to the special merger regime.

A special merger regime applies to the water sector in England and Wales because the lack of competition in the sector means that we need to use comparisons in the regulation of the sector. As each of the water companies is effectively a regional monopoly we use comparative information to ensure that customers are paying a fair price for their water, identify good performance and set incentives for companies to improve. The special merger regime recognises that mergers between companies within the water sector may prejudice our ability to carry out these functions.

Since 2004 any merger between two or more appointed companies, where one or both companies has an annual regulated turnover that exceeds £10 million, must be referred to an in-depth Phase 2 inquiry⁷. This is effectively an automatic reference for

⁴ See Mergers: Guidance on the CMA's jurisdiction and procedures, CMA (chapter 4).

⁵ See section 32 of the Water Industry Act (as amended)

⁶ If a water company chooses to exit the non-household retail market then that retail business would be transferred to a water supply licensee.

⁷ See section 33 of the Water Industry Act 1991 (as amended).

all incumbent water company mergers because only the 6 small water companies currently have annual regulated turnovers of less than £10 million.

1.2 The new special merger regime under the Water Act 2014

In the Government's view the existing special merger regime within the Water Industry Act 1991 acts as a disincentive to potential beneficial mergers between undertakers and creates uncertainty when a merger is proposed or has taken place.⁸ In its Water for Life White Paper which proposed changes to the special merger regime, Defra stated that:

- mergers can be a strong driver for improving the efficiency of companies, leading to improved service and lower costs that can be passed on to customers;⁹ and
- requiring that all water industry mergers to be subject to an (expensive) in-depth investigation reduced the likelihood of potential mergers between water companies and the scope for water companies to be taken over by more efficient operators and any resulting benefits.¹⁰

The Water Act 2014 addresses these issues by amending the Water Industry Act to allow the CMA to determine in Phase 1 of a merger inquiry whether to make a merger reference to Phase 2, or to accept undertakings to compensate for the loss of a comparator in lieu of a reference. This will mean that not all qualifying mergers will need to be referred to the in-depth Phase 2 CMA inquiry group-led review.¹¹

The CMA can conclude that a Phase 2 review is not necessary if:

- the merger arrangements are not sufficiently far advanced, or not sufficiently likely to proceed to justify making a reference; or

⁸ Paragraph 10, Water Act 2014, Explanatory Notes.

http://www.legislation.gov.uk/ukpga/2014/21/pdfs/ukpgaen_20140021_en.pdf

⁹ Paragraph 5.5.3, Water for life, Defra, 2011.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228861/8230.pdf

¹⁰ Paragraph 5.5.1, Water for life, Defra, 2011.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228861/8230.pdf

¹¹ A Phase 2 merger inquiry can take up to 36 weeks. Mergers: Guidance on the CMA's jurisdiction and procedure, CMA.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers_Guidance.pdf

- the merger is not likely to prejudice Ofwat's ability, in carrying out its functions by virtue of the Water Industry Act 1991, to make comparisons between water enterprises;¹² or
- the merger is likely to prejudice that ability, but the prejudice in question is outweighed by relevant customer benefits relating to the merger; or
- there are appropriate UILs from the merger parties which remedy, mitigate or prevent the prejudicial effect on Ofwat's ability to make comparisons between water enterprises resulting from the merger.¹³

Relevant customer benefits are defined in the Water Industry Act 1991 as lower prices, higher quality or greater choice of goods or services or greater innovation.¹⁴ These benefits must accrue to the customers of the merger parties¹⁵ within a reasonable period as a result of the merger and be unlikely to accrue without the merger.¹⁶ The Water Act 2014 changes will also require the CMA to keep under review the £10 million turnover threshold and condition where water companies should not be referred to a Phase 2 merger investigation, and to advise the Secretary of State from time to time whether this threshold is still appropriate.¹⁷

Figure 3 sets out the Phase 1 process following the Water Act 2014.

¹² Section 33A of the Water Industry Act 1991 (when amended)

¹³ Section 33D of the Water Industry Act 1991 (when amended)

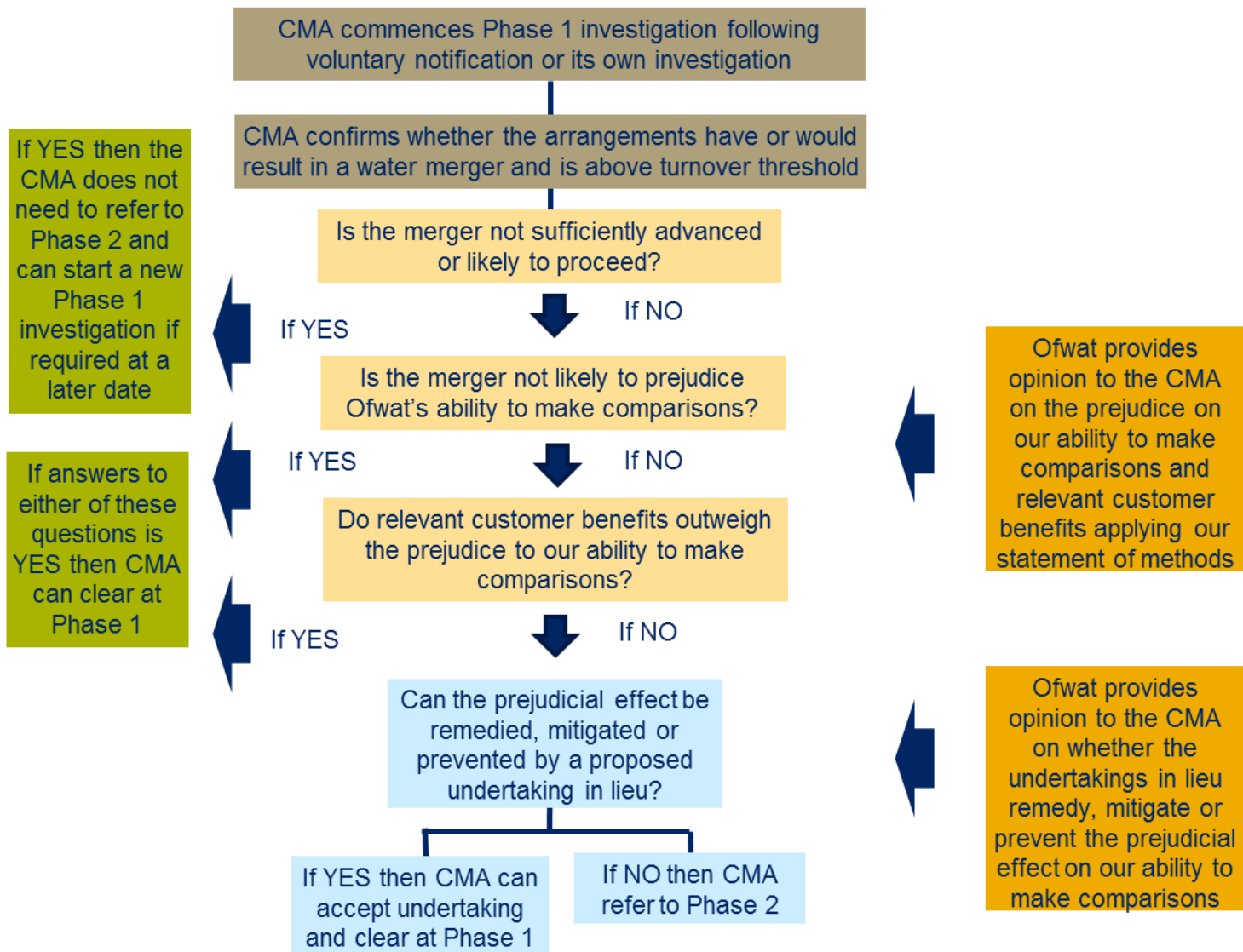
¹⁴ Paragraph 7 (1) (a) of Schedule 4ZA of the Water Industry Act 1991

¹⁵ Paragraph 7 (4) of Schedule 4ZA of the Water Industry Act 1991

¹⁶ Paragraph 7 (2) of Schedule 4ZA of the Water Industry Act 1991

¹⁷ Section 33 (6A) of the Water Industry Act

Figure 3: Phase 1 merger regime process (following the Water Act 2014)



1.3 Ofwat's role under the new special merger regime

We have an important role under the new special merger regime. Within Phase 1 of the merger inquiry, the CMA must request, and Ofwat must provide, its opinion on:

- whether the merger is likely to prejudice Ofwat's ability, in carrying out its functions, to make comparisons between water enterprises, and if so,

- whether the prejudice in question is outweighed by any relevant customer benefits relating to the merger.¹⁸

If, after considering Ofwat's opinion, the CMA considers it is under a duty to make a merger reference it may instead accept UILs which remedy, mitigate or prevent the prejudicial effect on Ofwat's ability to make comparisons.¹⁹²⁰ Before deciding whether or not to accept an undertaking, the CMA must request and consider Ofwat's opinion on the effect of the undertakings.²¹

1.4 Statement of methods

The changes made by the Water Act 2014 also state that Ofwat must prepare and keep under review a statement of methods.²² The statement of methods must in particular set out:

- the criteria to be used for assessing the impact of a merger on Ofwat's ability to make comparisons;
- the relative weight to be given to the criteria.

Ofwat must use this statement of methods when providing an opinion to the CMA of the likely prejudice to Ofwat's ability to make comparisons and whether the prejudice is outweighed by relevant customer benefits.²³

¹⁸ Sections 33A(3) and Section 33B of the Water Industry Act 1991 (when amended)

¹⁹ Section 33D(1) and (2) of the Water Industry Act 1991 (as amended)

²⁰ When considering undertakings in lieu the CMA must have regard of the need to achieve as comprehensive solution as reasonable and practicable to the prejudicial effect

²¹ Section 33D(6) of the Water Industry Act 1991 (when amended)

²² Section 33C of the Water Industry Act 1991 (when amended)

²³ Section 33B(2) of the Water Industry Act 1991 (when amended)

2. Why comparisons are important

This chapter sets out:

- why comparisons are important to the regulation of the water sector;
- how we currently use comparators; and
- how our use of comparators could change in the future.

2.1 Why comparisons are important

Water companies are regional monopolies. They are therefore not subject to the same market forces as companies in competitive sectors. The Water Industry Act provides us with powers and duties to regulate water companies. We regulate water companies in line with our statutory duties, in particular to further the customer objective, to secure that water companies carry out their functions and are able to finance their activities (and long term resilience for English water companies). We also have other duties which include promoting efficiency and contributing to sustainable development.²⁴

Comparative regulation has underpinned the way we have regulated the water and sewerage sector since privatisation. We use comparisons both during the price review process, for example in setting wholesale and retail price limits or service quality requirements, and between price reviews, for monitoring and enforcement and spreading best practice. Making comparisons between companies is one of the key tools we have, and it is recognised as such in the Water Industry Act.

Comparative regulation provides a number of benefits²⁵:

- It can improve cost estimation as we are better able to assess the true costs of water companies, as we are able to compare costs across a number of independent firms operating in similar circumstances;
- It can provide an impartial view of the performance of water companies by allowing comparisons to be made across the sector;

²⁴ Water companies are also subject to regulation from other bodies such as the Environment Agency and the Drinking Water Inspectorate.

²⁵ Adapted from benefits of comparative regulation set out in the Sale of Gas Networks by National Grid, NAO,

- It helps us overcome imperfect information, better allowing customers, investors, us and other stakeholders to assess the performance of companies;
- It provides a greater incentive for independent companies and their management to outperform their peers in the water sector;
- It provides greater incentives for innovation by facilitating a variety of different approaches to attempting to outperform price controls and other companies in the sector.

Losing an independent company through a merger could reduce the number of comparators we have available. Having fewer comparators could make it more difficult for us to make meaningful comparisons.

The first question that we must address under the new regime asks us to consider this impact on our ability to carry out our functions. Specifically it asks whether a water merger is not likely to prejudice our ability, in carrying out our functions, to make comparisons between water enterprises.

The loss of a comparator from a merger can affect our ability to make comparisons in a number of ways:

- It can remove a high performing company from our comparisons, which could impact on our benchmarks, reducing the scale of challenge for the industry as a whole;
- It would reduce the number of independent observations in our benchmarking, potentially impacting on the confidence that we can have in this benchmarking, which may be made worse with each successive merger as the number of independent comparators reduces;
- It could remove companies with important similarities or differences to other companies, making comparisons with other companies more difficult.

Mergers could also have a beneficial effect. For example they could remove a poorly performing company or they could create new innovative structures.

2.2 Our current use of comparators

We currently use comparators across three main areas of activity:

- to set price limits;
- to monitor and incentivise service quality; and
- to carry out ongoing monitoring, enforcement and spreading best practice.

2.2.1 Comparisons used to set price limits

One of our primary functions is to set price control limits, which determine the amount of revenue water companies receive during the subsequent price control period. The price control protects customers from excessive prices, while incentivising companies to make efficiency improvements and enables efficient companies to finance their activities. As an example Figure 2.1 sets out the overall approach to setting price control in the PR14 which set revenues for the period 2015-20.

Figure 2.1 sets out the overall approach to the 2014 price review of the price control

One of the most important aspects in the determination of revenue limits is

Wholesale controls		Retail controls	
Water	Wastewater	Household	Non-household
Monopoly service Total revenue control set for five years Cost assessment based on upper quartile performance using econometric modelling, supplemented by special factor cost claims for areas not covered. Expenditure split into money recovered in period (through Pay as you go (PAYG) and run-off of the regulatory capital value (RCV)) and money recovered over time (through the RCV) Companies receive a return on the RCV based on the weighted average cost of capital (debt and equity)		Monopoly service Total revenue control set for five years Cost assessment based on average cost to serve (adjusted for special factors such as bad debt) Companies receive a margin on costs	Competition introduced in 2017 Average revenue controls per customer type set for two years Companies must offer default tariffs which comply with control but not all customers have to remain on these Revenue control based on average cost to serve with a retail margin

identifying the level of allowed expenditure. At PR14, for the first time, we set separate price controls for wholesale and retail activities, meaning separate assessments of wholesale water, wholesale wastewater, non-household retail and household retail costs were made. Each water company will know more than the regulator about its future costs and efficiency and so we used comparisons between water companies for each price control to help overcome the information asymmetry and identify an efficient expenditure allowance. Some detailed examples of our use of comparators in the development of price limits are:

- **Comparisons through econometric modelling:** We used a suite of econometric and unit cost models to determine wholesale cost allowances at

PR14.²⁶ Water and wastewater were assessed separately. For water, we used econometric models to assess total expenditure (totex) using panel data from 18 companies over a 5 year period. For wastewater, we used econometric models to assess base expenditure (for 10 companies over 7 years) and unit cost models to assess enhancement expenditure.

- **Comparisons in assessing special factor claims:** In determining the totex allowance we considered a number of special factor claims from companies, some of which were assessed through comparisons between companies. For example, we assessed one company's claim for additional energy cost allowances by comparing its pumping head and energy costs as a percentage of totex across the industry.
- **Comparisons using retail average cost to serve:** Our assessment of household retail price limits used an industry-wide average cost to serve (ACTS) as its starting point.²⁷ Drawing on data from each of the 18 companies we calculated separate ACTS for different customer types i.e. for measured and unmeasured water-only, wastewater-only and water-and-wastewater customers.²⁸ We also considered whether any company-specific (or special factor) adjustments should be made, particularly relating to the area of bad debt costs. Our assessment of bad debt cost related adjustments included comparisons of companies' bad debt management practices and the relative deprivation of the areas served by each company.

Appendix 2 provides further examples of our use of comparators for assessing costs and setting price limits at PR14. Further details of our price control methodology are set out on our website.²⁹

2.2.2 Comparisons used to monitor and incentivise service quality

At PR14 in addition to setting price limits we also considered the service quality and outcomes that companies would deliver over the 2015-20 period. To incentivise companies to meet or exceed the expectations of their customers we set two main types of incentive mechanism.

²⁶ Ofwat (2014) "Final price control determination notice: policy chapter A3 – wholesale water and wastewater costs and revenues".

²⁷ Ofwat (2014) "Final price control determination notice: policy chapter A5 – household retail costs and revenues".

²⁸ The average cost to serve a water-only customer was calculated as the simple unweighted arithmetic average of all 18 companies' cost to serve a water-only customer, but the average cost to serve a sewerage-only customer was calculated as the simple unweighted arithmetic average of the 10 WaSCs' cost to serve a sewerage-only customer.

²⁹ Further details on the approach taken at PR14 are available on Ofwat's website, see <http://ofwat.gov.uk/pricereview/pr14>

- **ODIs and performance commitments.** Companies' performance commitments set out target performance levels. While some performance commitments were reputational, other commitments had financial ODIs which set out the implications, in terms of rewards and penalties, of exceeding, meeting or failing to meet these commitments.
- **The SIM** comprises quantitative and qualitative components which measure customers' overall satisfaction with the service levels they receive from companies. Under the SIM companies are rewarded or penalised financially for their performance relative to the rest of the industry. The SIM is incorporated into the household retail price control for all English and Welsh companies. In the absence of the opening of retail activities to competition for all non-household customers in Wales, we use a separate SIM to measure and incentivise non-household retail performance of the two Welsh water companies. This uses comparisons of the performance of the Welsh companies to those in England.

We also currently annually monitor and publish company performance against a range of service quality and other measures. While as a consequence of PR14 and recent decisions, the performance measures we require companies to publish is likely to change, the performance measures companies reported in 2010-15 include:

- customer experience: the SIM score, internal sewer flooding incidents and water supply interruptions;
- environmental impact: greenhouse gas emissions, sewerage pollution incidents, serious sewerage pollution incidents, discharge permit compliance and satisfactory sludge disposal;
- reliability and availability: water non-infrastructure serviceability, water infrastructure serviceability, sewerage non-infrastructure serviceability, sewerage infrastructure serviceability, leakage and security of supply index.

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Appendix 2 presents some examples of our use of comparisons in monitoring and incentivising service quality.

³⁰ See, for example, http://www.ofwat.gov.uk/regulating/casework/reporting/rpt_los2013-14performance

³¹ We also monitor and publish data on financial performance

2.2.3 Comparisons used to carry out ongoing activities in relation to monitoring, enforcement and spreading of best practice

We make comparisons in our on-going activities to monitor performance, undertake enforcement action and identify and spread best practice. Some examples of Ofwat's use of comparators in these areas include the following.

- **Board leadership and transparency:** following the publication of a set of principles in January 2014,³² we published a commentary in June 2014 on all companies' codes including a breakdown of whether or not the proposed codes would allow companies to meet the principles in each area.³³ This highlighted the companies that performed well in this area and we encouraged other companies to move towards this best practice.
- **Social tariffs:** We undertook a survey of companies' approaches to social tariffs in 2013, following which instances of best practice were identified and highlighted to the industry (through an industry workshop). This work contributed to the high take of up social tariffs by companies in their business plans.
- **Customer redress:** through the qualitative use of comparators we were able to identify which companies were 'leaders of the pack' with respect to the implementation of alternative dispute resolution (ADR) processes. These companies were then asked to take a prominent role in taking the industry forward.
- **Interim determinations of K (IDoKs):** where we use comparators to assess the robustness of company claims for changes to price limits during a control period. When assessing these claims we aim to identify the change in costs which an efficient company would have incurred as a result of the change in circumstances and if so whether that justifies a change in a company's price control. As part of this we make comparisons across the industry to understand whether a company has been particularly affected by the circumstances which it has claimed have given rise to the additional costs incurred and whether the company has taken appropriate steps to mitigate the effects of those circumstances on its costs.

Appendix 2 sets out examples of where we use comparisons for on-going monitoring, enforcement and spreading best practice.

³² See Ofwat (2014) "Board leadership, transparency and governance – principles", January, http://www.ofwat.gov.uk/regulating/gud_pro20140131leadershipregco.pdf

³³ See Ofwat (2014) "Ofwat's commentary on water companies' governance codes", June, http://www.ofwat.gov.uk/regulating/pap_res201406govcodecomment.pdf

2.3 How our use of comparators could change in the future

Our approach to regulation and therefore how we use comparators is likely to change going forwards. We have already set out some of the changes that we would do, for example the introduction of non-binding sub-limits for network plus during the 2015-20 period;³⁴ whereas some are facilitated by changes introduced by the Water Act 2014, such as upstream competition from 2019; and some we may consider for the next or subsequent price controls, such as binding sub-limits for different services.

Our approach to regulation and our use of comparators could change from:

- Changes in key elements to the PR14 price control – for example a move from an average to efficient cost to serve for retail.³⁵
- Changes introduced during the 2015-20 period – for example the introduction of non-household retail competition³⁶, the abstraction incentive mechanism and network plus sub-limits³⁷;
- Potential longer term changes from upstream competition (i.e. competition in some of the non-retail elements of the control)³⁸ and binding service level sub-limits (where sub-limits could be introduced for individual services, such as water resources, water storage, water distribution, water treatment, sewerage collection, sewerage treatment and sludge treatment and sludge disposal).

Further details of possible regulatory changes and the potential impact on our use of comparisons are given in Appendix 2.

³⁴ Page 160, Ofwat (2014), Setting price controls for 2015-20 – final methodology and expectations for companies business plans

³⁵ Page 97, Ofwat (2013), Setting price controls for 2015-20 – final methodology and expectations for companies business plans.

³⁶ Non-household retail competition – introduces retail competition to all non-households in England and non-households above 50MI/d in Wales

³⁷ Network plus – introduces non-binding sub-limits for:

- Water; covering raw water distribution, water treatment and treated water distribution, but not water resources; and
- Wastewater; covering sewerage collection and treatment but not sludge treatment, recycling and disposal.

³⁸ Upstream covers storing, treating and distributing water and collecting and disposing of sewerage

3. Principles for assessing mergers

The way we regulate has changed and will continue to change in the future as we embed our new strategy. We have developed a set of high level principles which will guide our approach to mergers. These principles have been developed based on our use of comparators and the potential impact of a merger on those comparisons. We have used these principles as the basis for the development of the criteria in our statement of methods, which is set out in Appendix 1.

- Each merger will be considered on its merits, taking full account of its benefits.
- Any merger has the potential to prejudice Ofwat's ability to make comparisons.
- A merger between companies whose scope of activities does not overlap is unlikely to significantly prejudice our ability to make comparisons.
- A merger involving a high performing company in terms of efficiency/service can prejudice our ability to set cross industry benchmarks.
- Each merger may permanently reduce the number of independent comparators in the monopoly parts of the value chain; and as a result the detriment to the comparative regime may increase for each successive merger.
- A merger can lead to the loss of a company with important similarities to the remaining companies. It might, for example, operate in similar conditions and face similar issues.
- A merger can lead to the loss of a company with important differences to the remaining companies, which for example could reduce the scope of the development of best practice.
- It might be possible for us to amend our approach to offset, to an extent, the impact of the loss of a comparator;
- A merger has the potential to create customer benefits which could outweigh the prejudice to our ability to make comparisons.
- UILs may be appropriate to remedy, mitigate or prevent the prejudice to our ability to make comparisons.

Our first principle is that we will consider each merger on its merits but below we discuss what types of issues we think will be important.

3.1 Type of companies merging

Any reduction to the number of comparators can have an impact on the robustness of our analysis by reducing the number of independent observations. We currently have a higher number of water comparators so the loss of a water comparator is likely to have less impact than the loss of a sewerage comparator. Therefore the potential detriment on the robustness of our analysis will be greater for a merger which would reduce the number of sewerage companies than one that reduces the number of water companies. It follows that a whole company merger between two water and sewerage companies has the greatest detriment to Ofwat's ability to make comparisons. This is because it will cause us to lose both a water comparator and a sewerage comparator. We expect the detriment from the loss of a comparator to increase for each successive merger as fewer comparators would remain.

3.2 Performance of merging companies

If at least one of the merging companies is leading/high performing in some areas, there is a greater risk of detriment for customers than if both companies are poor performers. This is because there is a risk that a high performing comparator might be lost as a result of the merger which would have a detrimental impact on cross industry benchmarks, reducing the scale of challenge for other companies in the sector.

3.3 Loss of a company with important similarities

A merger can lead to the loss of a company with important similarities to the remaining companies. For example a merger between contiguous companies could affect our ability to make comparisons across companies that are operating in similar circumstances facing similar issues.

3.4 Loss of a company with important differences

A merger can lead to the loss of a company with important differences from the remaining companies. These differences can take the form of best practice in some areas or the use of innovative approaches. The loss of these important differences can have a detrimental impact on our use of comparators.

3.5 It might be possible for us to amend our approach to reduce the impact of the loss of a comparator

The loss of a comparator could have a detrimental impact on the way that we currently regulate. It might be possible to change the way that we regulate to offset, to some extent, the potential detriment of the loss of a comparator.

3.6 A merger has the potential to create customer benefits

A merger has the potential to create customer benefits which could outweigh the prejudice to our ability to make comparisons. These customer benefits can take many forms but can include price reductions which result from operating synergies, reductions in financing costs, improved water resource management, higher service quality, greater choice or increased innovation, for example the creation of new or different company structures, such as a sewerage only company, or a very large water only company.

3.7 UILs may be appropriate to remedy, mitigate or prevent a prejudice to our ability to make comparisons

UILs could, in some circumstances, remedy, mitigate or prevent a prejudice to our ability to make comparisons. For example UILs could create the ability to make new comparisons, for example by committing to greater separation between the provision of different services and providing more detailed disaggregated data, which could facilitate more detailed or new forms of comparisons to be undertaken.

4. What benefits could a merger bring?

If we consider that a merger is likely to prejudice our ability to make comparisons between water companies, we will then consider whether the prejudice is outweighed by relevant customer benefits relating to the merger.

The Water Industry Act (as amended by the Water Act 2014) provides the CMA with the discretion not to make a reference for a Phase 2 CMA investigation if the prejudice is outweighed by the relevant customer benefits related to the merger.³⁹

This chapter sets out the key issues that we will consider when providing our advice to the CMA on whether the prejudice to our ability to make comparisons is outweighed by relevant customer benefits. Our understanding of potential benefits is based in part on previous water merger cases (see appendix 2) and will develop over time as we gain greater experience of the new regime.

This chapter:

- sets out what is, and what is not, a relevant customer benefit;
- identifies possible relevant customer benefits in terms of lower prices, higher quality, greater choice and greater innovation;
- sets out how relevant customer benefits need to be merger specific; and
- identifies how relevant customer benefits might change in the future.

4.1 Relevant customer benefits

Under the Water Industry Act, relevant customer benefits are limited to benefits to relevant customers in the form of **lower prices, higher quality, increased choice or greater innovation** in relation to goods or services.⁴⁰

Relevant customers⁴¹ are customers of the merging enterprises at any point lower in the chain of production and distribution. Therefore they might not necessarily be the final consumers and can include future customers. For example, it would be a relevant benefit of a merger if, as a result of the merger, a customer in an intermediate market obtained lower prices (or higher quality etc.) whether or not final

³⁹ See sections 33A(1)(c) for anticipated mergers and 33A(2)(b) for completed mergers.

⁴⁰ See paragraph 7(1) of Schedule 4ZA of the Water Industry Act 1991, as inserted by the Enterprise Act 2002.

⁴¹ Schedule 4ZA paragraph 7 of the Water Industry Act as inserted by the Enterprise Act 2002.

consumers were likely to benefit. The term customer is defined in accordance with Part 3 of the Enterprise Act⁴² which makes clear that the definition of a customer includes a customer who is not a consumer.⁴³ We note that relevant customer benefits can only accrue to customers (and customers of customers) of merger parties whereas the impacts of the merger on our ability to make comparisons will have wider effects on customers across the industry.

In addition to falling within the description of customer benefits described above we must be satisfied⁴⁴ that the benefit has **accrued as a result of the merger**⁴⁵, or is expected to accrue within a **reasonable time period** as a result of the merger, and that the benefit was, or is, unlikely to accrue without the merger or a similar prejudice.⁴⁶

4.2 Relevant customer benefits from past merger proposals

Mergers themselves can lead to a range of benefits but for benefits to be relevant customer benefits they must be:

- lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom; or
- greater innovation in relation to such goods or services.⁴⁷

Some of the benefits which have been considered and/or proposed in past water merger proposals are set out in Appendix 2.

4.3 Possible relevant customer benefits

Companies who are proposing a merger should consider the different types of customer benefit that the merger gives rise to. The list of historical benefits described in past water mergers is illustrative of the types of benefits that could be proposed. It should not be assumed that each of these benefits will be regarded as acceptable

⁴² See Schedule 4ZA paragraph 7(8) of the Water Industry Act 1991 as inserted by the Enterprise Act 2002.

⁴³ See section 129 Enterprise Act 2002. A consumer means any person who is (a) a person to whom goods are or are sought to be supplied (whether by way of sale or otherwise) in the course of a business carried on by the person supplying or seeking to supply them; or (b) a person for whom services are sought to be supplied in the course of a business carried on by the person supplying or seeking to supply them; and who does not receive or seek to receive the goods or services in the course of a business carried on by him.

⁴⁴ See Schedule 4ZA paragraph 7(2) and 7(3) of the Water Industry Act 1991 as inserted by the Enterprise Act 2002 respectively for anticipated and completed mergers.

⁴⁵ This is sometimes called the test of 'merger specificity'.

⁴⁶ See Schedule 4ZA paragraph 7(2) and 7(3) of the Water Industry Act 1991.

⁴⁷ See Schedule 4ZA paragraph 7(1) of the Water Industry Act 1991.

and is not meant to be exhaustive. We encourage merger parties to bring forward innovative proposals for benefits arising from their specific case although we expect them to be credible and securable. The following sections categorise potential relevant customer benefits that we might consider when providing our advice to the CMA.

4.3.1 Lower prices

There are several ways in which a merger could result in a reduction in costs which could lead to lower prices which we discuss below.

We would expect companies to present a clear mechanism for how any cost savings will be passed on to customers in the form of reduced prices. We will attach a high degree of certainty if, for example, companies agreed to licence modifications which, if the merger was cleared, reduced prices in the current control period and/or at the next periodic review. We will place less weight on cost reductions which are less certain to be passed on to customers in the form of lower prices for example through totex cost sharing mechanisms. In addition the further into the future adjustments take place the less certainty and weight we are likely to place on them.

In general merger cases savings in fixed costs might not be assumed to pass through to customers as they would not affect companies' optimal short-run pricing. However as water companies are monopolies, where we set prices based on average costs, savings in both fixed and marginal costs could be passed on to customers, although companies should be clear on the mechanism for how cost reductions would result in lower prices.

Operational cost savings

Operational cost savings comprise production and/or administrative efficiencies that can arise as a result of a merger. These efficiencies are usually understood through the concepts of economies of scale and economies of scope.

Economies of scale are where the average cost of production decreases with the scale of production. For example a merged company that had increased in size might not require a proportionate increase in the size of support functions and consequently the overhead costs per unit of production would decrease.

By rationalising such support functions and avoiding a duplication of shared activities, a merger may also be able to reduce the staff, IT and other infrastructure costs of the merged party. Cost savings were cited as a benefit in the 1990 merger of Three Valleys arising from staff reductions and also in the SAUR/Mid

Kent/General Utilities merger in 1997 relating to head office savings and reduced infrastructure development needs.

Economies of scope describes a situation where the joint production cost of different goods or services is less than the sum of the production costs of the goods or services by separate specialised firms. In the context of the water industry, economies of scope would refer to the potential for cost-savings due to the joint supply of:

- water and sewerage services as a whole;
- household and non-household customers;
- upstream and downstream services in either water or sewerage.

Economies of scope may come from the use of common inputs in the supply of water and sewerage services or reduced overhead costs through, for example, shared network management and common billing.

The use of common inputs may also increase buyer power and thereby generate further cost savings, for example a small water only company (WoC) may increase its buying power on merging with a larger water and sewerage company (WaSC) as together they represent a larger customer for third party suppliers which may be able to negotiate better rates.

The evidence on economies of scale and economies of scope from previous empirical studies is dependent on the size and type of the merging firms. We would therefore expect clear direct evidence of economies, for example post-merger implementation plans, rather than relying solely on models which predict cost savings.

Improved water resource management (from contiguous companies sharing/better planning of resources)

Mergers may lead to improved water resource management (or reduced wastewater treatment) where companies can benefit from either sharing resources or planning them better. This is especially true of contiguous companies. This can lead to relevant customer benefits by reducing costs and customer charges. For these benefits to be included we would need to understand why this improvement in resource planning was only possible following a merger and not through other means.

Water resource management improvements and associated enhancements to security of supply were given as potential benefits in the South East/Mid Kent merger

in 2006 and the SAUR/Mid Kent/General Utilities merger in 1997 which identified a range of water resource related benefits including integrating the network, leakage reduction and enhanced resource planning). Similarly Wessex/South West proposed a merger in 1996 which considered the more flexible use of an existing reservoir to be a benefit of the merger.

Reduced financing costs (from the ability to obtain more favourable terms as a larger company)

A merger could lead to reduced financing costs, or financial synergies from the ability of the companies post-merger to raise finance more cheaply than they could pre-merger. In PR14 we identified that small WoCs (Bristol Water, Dee Valley Water, Portsmouth Water, Sembcorp Bournemouth Water, Sutton and East Surrey Water and South Staffordshire Water) had higher debt costs of 25 basis points⁴⁸ which increased their weighted average cost of capital by 15 basis points. While a merger might not impact on embedded debt costs, it could reduce the costs of new debt for these companies.

4.3.2 Higher quality goods or services

A merger could increase service quality, for example by improving the security of supply, better customer service or reduced leakage rates. The SAUR/Mid Kent/General Utilities merger of 1997 cited improved service standards as a possible benefit, while Wessex/South West proposed improved customer service and enhanced customer confidence as potential benefits.

Improved service quality could be driven by sharing best practices where one company has better customer service practices and procedures and the other company could benefit from adopting those procedures post-merger. For these benefits to be included we would need to understand why this introduction of best practice was only possible following a merger and not through other means.

It may also be possible for two contiguous companies to increase their service quality for example by increasing their security of supply, through a better sharing of water resources. This was cited as a benefit to the 1996 proposed merger between South West Water and Wessex Water with the potential merged company having flexible use of Wimbleball reservoir, the linking of Wessex Water Services and South West Water trunk mains and the completion of South West Water's water grid. Again

⁴⁸ This was based on a notional capital structure and typical debt costs and so does not match precisely their individual actual debt costs, see section a.7.4.2.

http://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212riskreward.pdf

we would need to understand why these customer benefits would only be possible through a merger.

4.3.3 Greater choice of goods or services

Choice for customers in the water sector is limited. Household customers cannot change supplier and so their choice of retail services is limited. The range of tariffs and terms and conditions available to household customers is largely influenced by companies' statutory obligations such as providing a vulnerable customer tariff or through steers from our incentives such as SIM. However it is possible that if each company had different tariffs and terms and conditions pre-merger, post-merger the new entity may keep both sets of tariffs and terms and conditions resulting in a greater choice of for their customers (as customers may have a greater range of tariffs to choose from).

There is currently some limited choice for non-household customers consuming at least 5 Ml of water per year (50 Ml for customers of Welsh water companies) and in terms of differing products for large industrial customers (for example, different grades of water quality, non-potable, potable and polished).

Choice is likely to improve for non-household customers after April 2017 when all business customers and public sector, charitable and not-for-profit organisations served by English water companies will be able to choose their water supplier and sewerage service provider. This may result in companies offering a greater range of goods and services and therefore may increase potential merger benefits if the merged entity offers all the goods and services of both pre-merged companies.

4.3.4 Greater innovation in relation to such goods or services

A merger can also impact on the level of innovation. Two ways this may occur are discussed below.

Research and development (R&D) spending on innovation

A merger can impact on the effectiveness of R&D spending in a number of ways.

Firstly, the returns from R&D could be higher the more widely the results are applied. Consequently a merger could increase the returns to the R&D process. This could increase incentives for, and investment in, R&D. For example the effectiveness of R&D could be increased by encouraging employees of the merged firm to share information. This would improve the chances of finding innovative solutions and allow lessons on operational efficiencies to be shared across operating regions.

Horizontal mergers, i.e. mergers of companies providing the same services such as water companies, could be particularly conducive to such R&D complementarities. However it should be noted that as water companies effectively provide similar services with similar production processes there may be little additional innovation to be realised from merging.⁴⁹

A merger could also be detrimental to R&D if there are diminishing marginal returns to R&D investment, i.e. for every extra unit of R&D, the expected returns on that extra unit fall. In theory, a merging party that combines two existing R&D programmes (without tempering the scale of the R&D investment) might be expected to reach diminishing marginal returns quicker than two separate R&D departments. The extent to which diminishing marginal returns would materialise would depend on how far away each merging firm is from the minimum efficient scale of R&D, and where the merged firm will lie in relation to this threshold. Potentially of greater consequence are other factors such as differing cultures and internal rivalries which can often lead to R&D failures in mergers.

Creation of more innovative structures

A merger could itself lead to more innovative structures, such as a very large water only company or a sewerage only company. These could provide customer benefits by producing greater efficiency than created by existing industry structures.

4.4 Merger Specificity

Before we are satisfied that a benefit is a relevant customer benefit, we will have to be satisfied that the benefit would be unlikely to accrue without the merger and could not be achieved through other forms of permitted agreement between the parties. For example, in the Mid Kent/South East merger inquiry in 2007, the Competition Commission considered whether or not the water resource benefits put forward by the merger parties could be replicated by using flexible bulk supply agreements. We will look at any evidence submitted by the merger parties which indicates that the benefits from the merger could not be generated in any other way.

⁴⁹ Davidson, C. and Ferrett, B. (2006) 'Mergers in Multidimensional Competition'. *Economica*, vol. 74, pp695-712.

4.5 How might relevant customer benefits change in the future?

There are a number of changes and challenges which may affect our views of future relevant customer benefits. We discuss these below.

4.5.1 Improved resilience

Particularly given our new duty (in relation to English water companies) to secure the long-term resilience of water supply and wastewater systems, we expect water companies to take steps to enable them, in the long term, to meet the need for water supplies and wastewater services. Improved resilience from a merger could take the form of increased security of supply from having greater availability of a range of water resources. This could result in relevant customer benefits from improved service quality, such as a reduction in the possibility of hosepipe bans.

4.5.2 Impact of abstraction reform on water resource management

Some undertakers have surplus water resources under their licences that they do not abstract. However, as the licence has been given and may be used in full if the company decided to, no further licences can be issued. This has an adverse effect on new entrants to the upstream markets as they have limited or no access to incumbent's surplus water supplies. We are considering abstraction reform which may address this issue.

Any future abstraction reform would need to be taken into account when considering the benefits of merging. For example abstraction reform could reduce the potential future customer benefits of a company with scarce water resources merging with a contiguous company with surplus water resources.

4.5.3 Creating more competitive markets could reduce scope for benefits from mergers

As set out above in relation to the impact on comparators, there may be a number of changes to the way that we regulate. These could have an impact on relevant customer benefits:

- Changes introduced during the 2015-20 period – non-household retail competition⁵⁰ network plus sub-limits⁵¹;

⁵⁰ Non-household retail competition – introduces retail competition to all non-household customers of English water companies (non-household customers of Welsh water companies consuming at least 50MI/d will continue to be able to switch supplier).

- Potential longer term changes from upstream competition (i.e. competition in some of the non-retail elements of the control)⁵² and binding service level sub-limits (where sub-limits could be introduced for individual services such as water resources, water storage, water distribution, water treatment, sewerage collection, sewerage treatment and sludge treatment and sludge disposal).

Where competition or more disaggregated price limits are introduced, we would expect this to increase the pressure on water companies to be more efficient and increase service quality. Relevant customer benefits must be unlikely to accrue without a merger. Changes to the way we regulate could erode some of the potential relevant customer benefits from a merger as improvements in efficiency or quality would take place without a merger.

⁵¹ Network plus – introduces non-binding sub-limits for:

- Water; covering raw water distribution, water treatment and treated water distribution, but not water resources; and
- Wastewater; covering sewerage collection and treatment but not sludge treatment, recycling and disposal.

⁵² Upstream covers storing, treating and distributing water and collecting and disposing of sewerage

5. Undertakings in lieu

As set out in the Water Act 2014, if relevant customer benefits from a merger do not outweigh the likely prejudice to our ability to make comparisons, then the CMA may accept UILs instead of making a reference for a Phase 2 inquiry.⁵³ UILs must remedy, mitigate or prevent the prejudice to our ability to make comparisons from a merger. Before deciding on whether to accept UILs the CMA must request and consider our opinion on the effect of the undertakings offered.⁵⁴

This chapter sets out the key issues that we will consider when providing our advice to the CMA on the effect of the undertakings offered. This chapter describes:

- the background to UILs;
- the principles of a 'good' UIL;
- potential types of UIL;
- undertakings and remedies in previous water merger cases; and
- our approach in the future.

5.1 Background to UILs

UILs are for remedying, mitigating or preventing the prejudicial effect of a merger on our ability to make comparisons⁵⁵. When considering undertakings the CMA must have regard to the need to achieve as comprehensive a solution as reasonable and practicable to the prejudicial effect on our ability to make comparisons.⁵⁶ The CMA may also have regard to the effect of undertakings on relevant customer benefits from the merger.⁵⁷

Once an undertaking is in place and a merger has proceeded it may be varied, replaced or released by the CMA.⁵⁸ The CMA must consider any representations made to make a change to or vary an undertaking as soon as reasonably practicable.⁵⁹

⁵³ Section 33D (1) of the Water Industry Act as amended

⁵⁴ Section 33D (6) of the Water Industry Act as amended

⁵⁵ Section 33D (2) of the Water Industry Act as amended

⁵⁶ Section 33D (4) of the Water Industry Act as amended

⁵⁷ Section 33D (6) of the Water Industry Act as amended

⁵⁸ Section 33D (8) of the Water Industry Act as amended

⁵⁹ Section 33D (10) of the Water Industry Act as amended

5.2 Undertakings and remedies in previous water merger cases

UILs have not previously formed part of Phase 1 of a water merger inquiry. However the Competition Commission (one of the CMA's predecessors) has previously considered remedies as part of a Phase 2 water merger inquiry. Remedies and undertakings proposed in previous mergers or potential mergers have included:

- Prohibition – Severn Trent/Wessex and South West;
- Divestment – Vivendi/Southern – divestment of Three Valleys Water and stake in South Staffordshire Water (did not proceed); and
- Customer cost savings – South East/Mid Kent (one off rebate and opex reduction in PR09).

Appendix 2 provides further details of remedies and undertakings proposed in previous mergers or potential mergers.

5.3 Principles of a 'good' UIL

We consider that a good UIL (or package of undertakings) should provide as comprehensive a solution as possible to the prejudicial effect on our ability to make comparisons as a result of a merger. However, it will not necessarily restore us to exactly the same position in terms of our ability to make comparisons which we were in pre-merger. We consider that an undertaking should adhere to the following key principles. It should:

- provide a clear cut solution in addressing the prejudice caused by losing a comparator (i.e. there should be no material doubts on the effectiveness of the UILs). Ofwat, and therefore water customers, should not bear significant risks that UILs will have the requisite impact on our ability to make comparisons (but with the understanding that it not always possible to fully anticipate all effects of the UILs). UILs should therefore have a high degree of certainty that they will work;
- be able to be assessed and implemented with the resources available at phase 1;
- cause minimal adverse effects;
- have the appropriate duration and timing (addressing the adverse effects quickly is preferable);
- be practical, that is, if monitoring and enforcement is required it must be effective and clear to us, the CMA and merger parties what is going to be done and the implications;
- be proportionate to the prejudicial harm identified; and
- try to maintain any relevant customer benefits as far as possible.

In Phase 1 of a merger investigation, we will want to be confident that the likely prejudice will be resolved by means of the UILs offered without the need for a Phase 2 investigation. We consider that UILs are only appropriate where the remedies proposed to address them are clear cut, i.e. without material doubts about their overall effectiveness and capable of ready implementation within the timeframes of a Phase 1 investigation. This mirrors the CMA's approach to UILs in the general merger regime. We would not expect that every merger will be resolved at Phase 1. It should be emphasised that the final decision to accept UILs rests with the CMA, after considering Ofwat's opinion.

5.4 Potential types of undertakings

UILs can be structural such as the divestment of part of the merged business or behavioural such as a formal commitment from merger parties about future conduct. The CMA has stated that it is more likely to accept structural UILs than behavioural UILs in Phase 1 general merger cases,⁶⁰ although it notes that behavioural undertakings may be more suitable in markets in which there is already a significant degree of regulation.⁶¹⁶²

The acceptability of an undertaking to Ofwat will depend on the circumstances involved and the level of prejudice that a merger is likely to cause to our ability to make comparisons. When assessing potential undertakings we will consider both the prejudice to our ability to make comparisons now, but also what measures might assist our ability to make comparisons in the future. This could include creating the ability to make comparisons in new areas, by for example creating separate management, licencing, accounting or reporting of specific water or wastewater services. For example an undertaking could separate out retail or water resources from treatment and networks. The greater the degree of independence and separation of these services, the greater benefit this is likely to bring in providing comparisons in the future.

The following are provided as an indication of potential undertakings and are not intended to be comprehensive. We would particularly welcome undertakings that created new or innovative comparators.

⁶⁰ Paragraph 5.20, Office of Fair Trading (2010), Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance.

⁶¹ Paragraph 5.43 Office of Fair Trading (2010), Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance.

⁶² The CMA is considering behavioural undertakings in the Inter City Railways / InterCity East Coast franchise merger inquiry <https://www.gov.uk/cma-cases/intercity-railways-limited-intercity-east-coast-franchise>

5.4.1 Divestiture of other water enterprises

A merging party could undertake to divest itself of a holding in one or more other water enterprises. Where this would appropriately restore our ability to make comparisons (that is, it creates an additional independent comparator) it could provide an effective and proportionate remedy.

5.4.2 Partial divestitures

Undertakings to divest part of a water enterprise (rather than full divestiture) could, in some instances, provide an effective and proportionate remedy to the identified prejudice from the merger. This would be the case when our ability to make comparisons would be restored by divestiture of part of one of the merging companies. A partial divestiture might be of a stand-alone, going-concern business or of physical assets, for instance those serving part of a company's licence area or divestiture of water or sewerage activities. A partial divestiture could also involve the reduction in the equity holding of a company, however such a reduction would need to give the water company management independence where this was not previously the case.

5.4.3 Separate administration

Separate administration could involve an undertaking to maintain separate management or separate accounting arrangements of the company taken over or to create separate management or accounting arrangements within the merged entity. The greater the degree of independence or separation of the company or services then the greater the comparator benefits, although unless a company or service is under independent ownership then it is unlikely to be a fully independent comparator. A lesser but related benefit may also be created by having separate cost information (for example split by upstream services) within the merged company

5.4.4 Amending licences

An undertaking to agree to amend one or both of the company's licences could amount to a structural undertaking (for example introducing conditions which require the separation of certain activities into separate business units), or a behavioural undertaking (for example the provision of information). As with other areas, the greater the level of independent data created, the greater the benefit this is likely to have.

6. The Phase 1 water merger process and our expectations of merger parties

This chapter sets out the Phase 1 water merger process following the Water Act 2014, including our our expectations of merger parties and the process we expect to follow.

6.1 Legal requirements

The Water Act 2014 introduces a 'two stage' process for water mergers. This will mean that not all qualifying mergers will need to be referred to the in-depth Phase 2 CMA inquiry group-led review.⁶³ The existing Phase 1 merger inquiry process assesses whether the merger is a water merger and whether at least one of the water companies meets a minimum turnover threshold of £10 million. If these tests are met then the merger is referred to a detailed Phase 2 investigation. The Water Act 2014 adds in additional tests to allow the CMA to conclude within Phase 1 that it would not need to refer the merger for a more detailed investigation if:

- the merger is anticipated and the arrangements are not sufficiently advanced or unlikely to proceed;
- the merger is not likely to prejudice our ability, in carrying out its functions, to make comparisons between water enterprises;⁶⁴ or
- the merger is likely to prejudice that ability, but the prejudice in question is outweighed by relevant customer benefits relating to the merger; or
- there are appropriate UILs from the merger parties which remedy, mitigate or prevent the prejudicial effect on our ability to make comparisons between water enterprises from the merger.⁶⁵

The ultimate decision on whether there is a requirement to undertake a Phase 2 investigation, and which (if any) undertakings to accept, rests with the CMA after considering our advice.

⁶³ A Phase 2 merger inquiry can take up to 36 weeks. Mergers: Guidance on the CMA's jurisdiction and procedure, CMA.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers_Guidance.pdf

⁶⁴ Section 33A of the Water Industry Act 1991 (as amended)

⁶⁵ Section 33D of the Water Industry Act 1991 (as amended)

6.2 Overview of Phase 1 process

Based on the general merger regime and the requirements under the Water Act 2014 there are potentially three main stages to the Phase 1 process:

- **Pre-notification:** 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. There is no formal time limit on these discussions, so merger parties are encouraged to open dialogue with Ofwat and the CMA at the earliest opportunity to enable all parties to consider their positions ahead of any formal phase 1 investigation.
- **Phase 1 investigation:** In the Phase 1 investigation the CMA will consider whether the merger will prejudice Ofwat's ability to make comparisons and whether relevant customer benefits arising from the merger would outweigh this prejudice. The CMA must request and consider Ofwat's opinion on these issues. Ofwat must provide its advice in accordance with its statement of methods. If merger parties have raised UILs by this stage of the process the CMA must also consider Ofwat's opinion on the effect of those UILs.
- **Consideration of UILs of a Phase 2 reference:** if the CMA concludes that a merger prejudices Ofwat's ability to make comparisons between water companies, and that this prejudice is not outweighed by relevant customer benefits, the merger parties will have the opportunity to propose UILs to offset that prejudice. If UILs are proposed the CMA must request and consider Ofwat's opinion on these undertakings before determining whether the UILs offered are sufficient to offset the prejudice.

6.2.1 Our expectations of merger parties

One of the objectives of the Water Act 2014 was to reduce the number of mergers being referred to an in-depth Phase 2 investigation as this acted as a disincentive to potentially beneficial mergers. Given the short timescales for the formal Phase 1 investigation and the need for robust analysis, this places significant importance on evidence provided by merger parties during the pre-notification and Phase 1 process.

Consistent with our strategy of companies taking responsibility for their relationship with their customers⁶⁶, we expect merger parties to have a good understanding of the potential impact of a merger, particularly in terms of relevant customer benefits. In their submission to us, we expect merger parties to set out:

⁶⁶ Cathryn Ross, March 2015, Regulating modern utilities: the future approach.

- the impact of the merger on our ability to make comparisons;
- the relevant customer benefits from the merger, and whether these outweigh the impact on our ability to make comparisons; and, if they do not;
- any UILs that would prevent, mitigate or remedy the impact our ability to make comparisons.

Our draft statement of methods sets out the criteria and weightings that we would apply to the assessment of a merger on our ability to make comparisons and relevant customer benefits. Our statement of methods also sets out the criteria on which we would expect to assess evidence provided by merger parties. We have also commissioned a report by Europe Economics into techniques for assessing the impact of mergers. To provide the best opportunity for assessment at Phase 1, merger parties should develop their submission in line with our statement of methods and take account of the report into evaluation methods developed by Europe Economics.

6.2.2 The potential timetable for the Phase 1 process

The Water Act 2014 does not specify a Phase 1 timetable for water mergers.⁶⁷ Table 6.1 sets out the potential timetable if the CMA's general merger regime timetable is applied to Phase 1 water mergers. This is based on the CMA's published guidance on jurisdiction and procedure.⁶⁸ In the light of the new water mergers regime the CMA will be revising its guidance on water mergers in due course. This will include a public consultation on the guidance. We are having further discussions with the CMA on how the timetable will work in practice.

Table 6.1 The potential timetable for the Phase 1 process

Timing	Party	Action
Pre-notification		
During pre-notification period	Merger parties	Merger parties contact Ofwat to identify potential merger and discuss merger process and Ofwat's information requirements. Merger parties are encouraged to contact the CMA at the same time.
	Merger parties	Merger parties submit draft of evidence to Ofwat.
Phase 1 investigation		

⁶⁷ The introduction of statutory deadlines for water mergers will require secondary legislation.

⁶⁸ CMA, 2014, Mergers: Guidance on the CMA's jurisdiction and procedure

Timing	Party	Action
Day 1	CMA	The 40 working day period for the Phase 1 investigation begins on the first working day after the CMA confirms that it has received a complete merger notice (or in the case of an own-initiative investigation that the CMA has sufficient information to begin) and that Ofwat has sufficient information to begin its assessment. ⁶⁹ Ofwat will expect to receive a complete merger impact assessment from the merger parties to have sufficient information to begin its assessment. Merger parties should provide confidential and non-confidential versions of the merger impact assessment
Day 1	CMA	The CMA start the assessment stage of the investigation by publishing an invitation to comment notice on their website (which is open for 10 working days) in order to understand third parties views on the merger.
Before state of play discussion	Ofwat	Ofwat sends draft opinion to the CMA on whether the merger would prejudice its ability to make comparisons and whether relevant customer benefits outweigh this prejudice.
Day 15 - 20	CMA	CMA holds state of play discussion with merger parties (typically by phone) which will set out whether it has no serious concerns and can clear the transaction of whether it has identified issues which require a subsequent issues meeting.
Before Day 40	CMA	For cases which raise no serious concerns CMA can clear the transaction and issue a clearance decision.
Day 25 to 35	CMA	Where CMA has not cleared the transaction, the CMA invites merger parties to an issues meeting and sends merger parties an issues letter stating core arguments for reference to Phase 2 and holds an issues meeting with the parties where parties have an opportunity to respond to the outlined concerns.
Before issues meeting	Ofwat	Ofwat sends its final opinion on the issues raised by the merger
Before or after issues meeting	Merger parties	Merger parties may provide comments on the issues statement either before or after the issues meeting.
By Day 40	CMA	CMA publishes notice of decision (with full decision published at a later date)
Consideration of UILs of a phase 2 reference		

⁶⁹ This will require a change to the merger notice

Timing	Party	Action
0 – 5 working days after parties given decision	Merger parties	Merger parties who wish to make offer of UILs provide these to the CMA, unless already provided. The CMA provides UILs to Ofwat.
Before CMA decision on UILs	Ofwat	Ofwat provides its opinion on UILs to the CMA.
Up to 10 working days after parties given decision	CMA	If no UIL is provided within 5 working days then CMA refers to Phase 2. CMA decides whether to provisionally accept UILs, taking into account Ofwat's opinion on the offered UILs. If CMA rejects UILs then transaction refers to Phase 2.
Within 50 working days of parties being given decision	CMA	CMA gives detailed consideration to terms of proposed UILs. CMA publishes draft UILs for third party comment. CMA decides whether to formally accept UILs, and either publishes notice of acceptance or refers the transaction to Phase 2.

6.2.3. The pre-notification discussions

Pre-notification discussions take place when parties to a merger have decided to notify a merger and wish to engage with Ofwat and the CMA in advance of its formal notification.⁷⁰ The formal process for Ofwat will be different to that of the CMA in that it will focus on the parties' submission on the impact of the merger rather than the CMA's formal notification submission. It is in the interests of both Ofwat and the merger parties that the parties' formal merger impact assessment submission to Ofwat is as well formed as possible as this will provide the best opportunity for parties to avoid an in-depth Phase 2 investigation. Given the short timescale for the Phase 1 investigation, pre-notification discussions will provide merger parties the best opportunity of providing a well formed submission.

The pre-notification process can assist both us and merger parties in a number of ways.

- It provides us with details on the merger, including its rationale and potential benefits.

- It allows merger parties to clarify our process and to take account of our views on the information we require as part of the formal merger impact assessment submission by the merger parties on the impact on our ability to make comparisons and relevant customer benefits;
- It allows merger parties to provide drafts of the evidence they intend to submit, and allow us to provide informal advice on these submissions, to allow the formal submission to be well formed. Any informal advice will be:
 - made on an informal 'without prejudice basis' and will not fetter our discretion to make an appropriate formal submission to the CMA;
 - made on a strictly confidential basis;
 - dependent on the information provided by the merger parties, and as there will not be time to test parties submissions, will assume the information provided is accurate; and
 - restricted to a limited number of occasions so that informal advice is not iterative although other informal pre-notification discussions are not limited.
- It allows merger parties to discuss with us any potential UILs that could prevent, remedy or mitigate any prejudice to our ability to make comparisons. We are particularly ready to engage with parties who acknowledge that the merger might create potential issues and wish to seek advice on how to resolve these.

6.2.4 Phase 1 investigation

The start of the Phase 1 investigation

The CMA has indicated that Phase 1 will begin when we and the CMA have sufficient information to begin our respective investigations. For us this will mean that we have all information that the merging companies wish to be considered in the Phase 1 investigation.

Merger parties merger impact assessment submission

We expect the merger parties merger impact assessment submission to set out:

- the rationale for the merger;
- the impact of the merger on our ability to make comparisons;
- the assessment of relevant customer benefits; and
- where appropriate, proposals for UILs

When making their submission, merger parties should be aware that we will assess the impact of the merger on our ability to make comparisons and relevant customer

benefits based on our statement of methods, which is set out in Appendix 1. Merger parties should also take account of the evaluation techniques set out in the Europe Economics report.

Merger party submissions that comply with our statement of methods are likely to have the most weight. To this end companies should consider the loss of a comparator and the resulting prejudice on our ability to regulate in terms of:

- setting price limits – for example setting cost benchmarks and comparing expenditure and financing costs across companies;
- service quality – for example comparing performance commitments and service quality across companies; and
- our on-going role in monitoring, enforcement and spreading best practice – for example comparisons of company Board leadership, transparency and reporting.

Companies should have regard to our statement of methods and address:

- whether the merger involves overlaps in the merger parties' scope of services;
- whether the merger involves the loss of an independent comparator;
- whether the merger leads to a loss of a comparator which changes benchmarks;
- the number and quality of independent observations that will remain after the merger;
- whether the merger leads to a loss of a comparator with important similarities for comparisons;
- whether the merger leads to a loss of a comparator with important differences for comparison; and
- whether there are alternative approaches available to Ofwat to offset the loss of this comparator.

Companies should consider relevant customer benefits, which are benefits that:

- lower prices;
- increase service quality;
- lead to a greater choice of services;
- lead to greater innovation;
- are a direct result of the merger (and unlikely to occur otherwise)
- accrue to customers (and their customers) of merger parties; and
- accrue within a reasonable period of time and are sustained.

Merger parties should monetise impacts where possible over 30 years and 5 to 10 years consistent with the statement of methods. Where monetised impacts are not possible merger parties should quantify or qualitatively assess impacts and provide an indication of scale, for example how these non-monetised impacts compare with the monetised impacts, together with supporting evidence.

To inform our assessment of the proposed benefits of a merger, merger parties should provide detailed evidence about the types of benefits which they anticipate will accrue, when those benefits will accrue, how likely these benefits are to accrue to customers, how long the benefits will last and which customers will benefit.

As a part of developing an evidence base, merger parties may wish to seek to demonstrate that customers support the proposed means of delivering benefits to them, and also that the proposed means of delivering benefits is customers' most preferred option i.e. that some alternative approach is not preferred by customers.

Merger parties should also describe how the benefits will be generated i.e. how the operation of the companies will be changed and how that will create the proposed benefits. For example, where cost savings are proposed, we will consider evidence on the details of how those cost savings may be achieved by the merging companies, for example in terms of clear and detailed post-merger implementation plan. This will help to show how likely it is that those cost savings will be secured and whether or not cost savings are likely to continue beyond the initial price control period. Likewise, if a merger is anticipated to give rise to improvements in quality of service or water resource management, merger parties should set out how those benefits will arise. It is important for merger parties to provide evidence that benefits can only be gained as a result of the merger and not through any other means. For example improved security of supply could be a benefit of merging but it could also potentially be realised through a flexible bulk supply agreement.

Merger parties should also set out how benefits, for example reductions in costs would flow through to benefits to customers. We will attach most weight to customer benefits which are certain.

To support their analysis merger parties should provide supporting data, spreadsheets, conclusions and evidence of customer support. We will place the most weight on evidence which:⁷¹

- is clear and transparent around approach and assumptions;

⁷¹ The first three of these criteria follow CMA guidance on the submission of evidence and the last two are in line with the principles used in PR14.

- is a complete description of the analysis;
- we are able to replicate;
- is robust and includes independent assurance; and
- has evidence of customer support.

Information should be provided in both confidential and non-confidential formats where applicable along with reasons for confidentiality where necessary. If suitable information is not included in the merger parties' merger impact assessment submission, then we will advise the CMA not to start Phase 1 of the merger investigation until such time as suitable information is presented to us.

Where merger parties analysis indicates that there may be prejudice to our ability to make comparisons we encourage companies to consider, evaluate and provide evidence for potential UILs which would mitigate any prejudicial effect.

The onus is on merger parties to provide enough evidence and a robust and thorough analysis to justify why merger should not proceed to Phase 2.

Further information from merger parties

We may need additional, or more comprehensive, information from the merger parties than is provided in the initial merger impact assessment submission (even though the information we have received is sufficient for the CMA to start its investigation). In this case we will ask for any such additional data, information or documents as soon as it is clear they will be necessary. However, given the short timescales replies also have to be supplied quickly which might be as short as one business day where necessary.

Information requests

Water companies are required to provide Ofwat with information that we reasonably require for the purposes of carrying out our functions under the Water Industry Act, including our functions of advising the CMA.⁷²

We would expect to share relevant information provided to Ofwat with the CMA. Given the short timescales in the Phase 1 process we encourage companies to send all information to Ofwat and the CMA at the same time.

⁷² See licence condition M.

Discussions with merger parties

We will continue to engage with and request information from merger parties as appropriate until we make our final submission to the CMA. We will also continue to engage with merger parties throughout the Phase 1 process on potential UILs of a reference to Phase 2.

We encourage merger parties and their advisers to liaise closely with our merger team during the lifetime of the case. Ideally, this process should start with pre-notification discussions.

The level of interaction required between merger parties and their advisers and our merger team will depend on the individual circumstances of the merger in question. It may be sufficient for the parties to liaise with the merger team by email on a periodic basis, alternatively it may be helpful for parties and our merger team to have conference calls and/or meetings. There is no fixed timetable as to when such contacts should occur. Merger parties may suggest such contacts if they consider they would be useful and we will agree to a meeting if we consider it appropriate.

The Phase 1 decision making process

We will assess the merger based on our statement of methods, taking into account the evidence provided by merger parties and the valuation techniques set out in the Europe Economics report. We will provide our evidence to the CMA.

The decision on whether to refer a merger to Phase 2 rests with the CMA.

We will publish our advice after the CMA makes its decision on whether the merger should be referred to Phase 2.

6.2.5 UILs

UILs are for the purpose of remedying, mitigating or preventing the prejudicial effect of the merger on Ofwat's ability to make comparisons.

Under the general merger regime after the publication of the CMA's merger decision notice, merger parties have 5 working days to provide UILs to avoid a phase 2 review. However, notifying parties can provide draft UILs as part of the merger impact assessment submission or during the Phase 1 investigation. We strongly recommend that where notifying parties consider that there may be concerns with the impact of the merger on our ability to make comparisons then they should consider possible UILs during the pre-notification phase and include proposals as

part of the merger impact assessment submission. This ensures that, if UILs are formally proposed following the merger decision, parties will be able to submit their proposed UILs rapidly, maximising the chance of acceptance.

In advance of the merger decision, our merger team can assist merger parties in understanding the functioning of UILs. Our merger team will also, where possible, provide guidance to parties on which of the possible remedies being considered by the parties might be more suitable. However our merger team is not able to formally agree with the parties whether a formal package of UILs would be acceptable to us. **It should be emphasised that although we must provide our opinion to the CMA on any UILs offered by the parties, the final decision on whether the UILs are acceptable rests with the CMA and not with Ofwat.**

If the CMA finds that its duty is to refer the merger for a Phase 2 investigation, merger parties have 5 working days after the CMA's merger decision notice, to provide UILs of a Phase 2 reference. We would then have to provide an opinion to the CMA on the effect of the UILs offered. Within 10 days of the decision notice the CMA will publish its provisional view on whether the proposed UILs can remedy the detriment caused by the merger.

There is then a period of a further 40 working days (that is a total of 50 working days after the merger decision notice) where the CMA will consider the proposed UILs in detail. We will then have the ability to provide more detailed comments on the proposed UILs at this stage and other third parties will also have the opportunity to comment on these final proposals. The CMA then makes the final decision as to whether the proposed UIL is appropriate and publishes a note of acceptance or refers the merger to Phase 2. In special cases the CMA may extend the period of 50 working days by a maximum of a further 40 working days.

6.2.6 Our approach to licence modifications

Companies that merge may come to Ofwat to seek a single appointment or licence. The instrument of appointment sets out the area for which the appointment is held, that is, the geographical area the monopoly water company operates in, and the conditions of that appointment. These conditions include charges, charges schemes, codes of practice, accounting information, ring fencing and service standards.

We consider that the introduction of a merged licence provides an opportunity to include standard licence conditions, where appropriate, to secure the benefits of the merger for customers, and introduce other measures that are expected to improve our ability to make comparisons in the future. We might also seek these changes

even if merged parties do not ask for a single licence. We would therefore expect updated licence conditions to include the following.

- Standard licence conditions where these are not already in the merging companies' licences, including, for example, 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.
- Any provisions which would ensure that the customers of the acquired company do not receive deterioration in service.
- Any requirements that will be placed on the merger parties in respect of separate accounting and outcome reporting between water or sewerage supply regions.
- Where appropriate, a modular licence and licence conditions which reflect the way that we regulate (we are developing a suite of modular licence conditions as part of our published 2015-16 forward programme).
- Any licence amendments required as part of undertakings, for example reductions in price limits.

The licence modification process will commence following the decision not to prohibit a merger by the CMA following the process required under the Water Industry Act 1991.

If companies are not proposing to accept these conditions to a merged licence then merger parties should indicate this, together with the reasons why in the merger impact assessment submission. The less certain that the benefits of the merger will be transferred to customer benefits, the less likely we will be able provide an opinion to the CMA that relevant customer benefits would outweigh the prejudicial effect on our ability to make comparisons.

Appendix A1: Our statement of methods

The Water Industry Act 1991 (as amended) requires Ofwat to publish a statement of methods which we must apply when forming an opinion on mergers⁷³. The statement of methods must include the criteria we will use for assessing the effect of any particular water merger on our ability, in carrying out our functions in the Water Industry Act, to make comparisons between water enterprises and the relative weight to be given to the criteria.

Our statement of methods is based on our duties, our strategy (which puts the focus on company ownership), our principles for assessing mergers and takes into account CMA merger guidelines.

Based on our general duties we would normally expect that, if a company was able to carry out and finance its functions pre-merger, then it should be able to do so post-merger. Consequently the assessment of the impact of the loss of a comparator is likely to be focused on the customer impact and, where relevant, our resilience duty.

This statement of methods sets out:

- The basis for our assessment (the counterfactual and the impact of our regulatory approach);
- The criteria for determining the impact on our ability to make comparisons and for the assessment of customer benefits;
- The weighting given to each criterion; and
- The approach for determining whether the prejudice is substantially outweighed by the relevant customer benefits.

A1.1 The counterfactual

Our assessment of the impact of a merger is based on both the factual (with the merger) and counterfactual (without the merger).

⁷³ Section 33C of the Water Industry Act 1991 as amended by the Water Act 2014

The counterfactual can be defined in a number of ways. At Phase 1, we will consider the effect of the merger compared with the most prejudicial counterfactual, that is, the counterfactual against which the merger would do most harm to our ability to make comparisons as long as we consider that scenario to be a realistic prospect. The aim in doing so at Phase 1 is to make sure that problematic mergers are not missed.⁷⁴

In practice, we will normally use the prevailing conditions for the foreseeable future as the counterfactual against which to assess the impact of the merger, i.e. both firms operating under independent ownership.

A1.2 Impact of our regulatory approach

When considering the impact of a merger we will also need to consider the regulatory regime under which the use of comparators or customer benefits needs to be evaluated. Typically we will use the prevailing form of regulation as the main basis for our assessment. However, we may use alternative scenarios where we believe conditions might change for example if we have made public statements about where our future regulatory approach might change whether this change has been implemented or not. Where there is less certainty about the evolution of the use of comparators we will use a scenario approach to the assessment, to assess whether future regulatory changes would have a material impact on our ability to use comparisons or customer benefits.

A1.3 Criteria for determining whether the merger would prejudice our ability to make comparisons

We will consider the loss of a comparator and the resulting prejudice on our ability to regulate in three key areas.

- Setting price limits – for example setting cost benchmarks and comparing expenditure and financing costs across companies.
- Improving service quality – for example comparing performance commitments and service quality across companies.
- Our on-going role in monitoring, enforcement and spreading best practice – for example comparisons of company Board leadership, transparency and reporting.

⁷⁴ This sentence mirrors the CMA's Merger Assessment Guidelines at paragraph 4.3.1; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf

When considering the impact of a merger, we will measure it against the criteria below. The criteria are based on the harm that a merger might do to our ability to make comparisons:

Criterion 1: The extent to which the merger involves overlaps

We consider that the greater the degree of overlap in merger parties' scope of activities, the more likely a merger is to prejudice our ability to make comparisons between undertakers. For example, a WaSC merging with another WaSC has a large degree of overlap (water, sewerage and retail services are all provided by both companies) and so is more likely to prejudice our ability to make comparisons. Conversely a WoC taking over the wastewater activities of a WaSC would have no overlap in the scope of services and so we would be less concerned about potential prejudice.

Criterion 2: Whether the merger involves the loss of an independent comparator

A water merger brings under common ownership or common control two or more undertakers. The merging undertakers continue to operate under separate licences (referred to in the Water Industry Act as the appointments) unless their licences are modified, which would require our approval. In the absence of licence changes, we can continue to receive separate information from each of the merging water enterprises and can continue to use this to make comparisons. However, in general, we believe that companies under common ownership may behave in similar ways and therefore a water merger may reduce the value of comparisons made by Ofwat. If a merger involves a water company which Ofwat does not use to make comparisons, for example a small water company, then we might not in practice lose an independent comparator.

Criterion 3: The extent to which the merger will change benchmarks

We will consider the relative performance of the pre-merger companies. If at least one of the merging companies is leading or high performing in some areas, there is a greater risk of detriment for customers than if both companies are poor performers. This is because there is a risk that a high performing comparator might be lost as a result of the merger, for example if the high performing company is taken over. In addition even if two high performing companies merge then a high performing comparator would be lost which would have a detrimental impact on cross industry benchmarks, reducing the scale of challenge for other companies in the sector. We acknowledge that a take-over by high performing company might improve the performance of a poorer performing company by providing improved efficiency or

service to a greater number of customers, although we will need evidence to demonstrate why this would be the case. We will consider the impact of the merger in each of the areas where we use cross industry benchmarks, and how these benchmarks might change if the merger takes place.

Criterion 4: The number and quality of independent observations that remain

We will consider the number and quality of independent companies that would remain after the merger. Any reduction to the number of comparators can have an impact on the robustness of our analysis by reducing the number of independent observations. We currently have 18 water comparators and only 10 sewerage comparators, so the loss of a water comparator is likely to have less impact than losing a sewerage comparator. So the potential detriment on the robustness of our analysis will be greater from a sewerage merger than a water merger. It follows that a whole company merger between two water and sewerage companies has the greatest detriment to Ofwat's ability to make comparisons. This is because it will cause us to reduce the number of independent comparators in wholesale water and sewerage and retail. We will consider the impact of the merger on the number and quality of comparators and whether this is likely to make our analysis less robust, for example by reducing the precision of our cost modelling, or make our ability to regulate more difficult, for example as there are insufficient companies to create effective competition for enhanced business plan status. We expect the detriment from the loss of a comparator to increase for each successive merger as fewer comparators would remain.

Criterion 5: A loss of a comparator with important similarities for comparisons

We will consider the extent to which the pre-merger companies are in similar circumstances to a limited number of other companies in the industry. If at least one of the merger parties are valuable comparators for the regulatory regime— perhaps for a subset of other companies in the industry, or in respect of one or more specific areas of operation, this would have potential for a greater detriment. For example a merger between contiguous companies could affect our ability to make comparisons across companies that are operating in similar circumstances facing similar issues. We will look at evidence where we have used or might use information about the merger parties to challenge or validate information from other companies

Criterion 6: A loss of a comparator with important differences for comparison

We will also consider the extent to which a loss of differences between the merger parties and other undertakers is important for performing our functions. If one or

more of the merger parties takes an approach which is different from other companies, it can be useful to us when making comparisons, for example in terms of spreading best practice or innovation. If there is a reasonable prospect that the different approach would be lost as a result of the merger, then this would produce a detriment.

Criterion 7: Are there alternative approaches available to us to offset the loss of this comparator?

We will consider whether we could amend our regulatory approach to offset the loss of this comparator. This could include using different econometric techniques or a different choice of a benchmark within the sample (for example upper quintile rather than upper quartile) which could offset, to some extent, the detriment to our ability to make comparisons.

A1.3.1 Weighting of the criteria on the loss of comparators

We will assess criterion 1 and 2 on the basis of a yes/no response, although we accept that this can sometimes be a matter of degree. If the answer to either question is no then it is unlikely that the merger would cause prejudice to our ability to make comparisons. If this is the case then we would not proceed with the assessment against the other criteria and would provide our opinion to the CMA on this basis.

We will apply equal weights to each of the other criteria. That is, a customer loss of £1 million under criterion 3 will be weighted the same as customer loss of £1 million under criterion 4, 5, 6 and 7. The size of the impact of a merger under some criteria could be larger than others. To take account of this we will monetise impacts where possible, i.e. convert impacts into a £m impact. This will identify the scale of impact and the relative weight of that impact against other criteria.

We will take account of the impact over time. To allow impacts to be compared over time we will discount future impacts to reflect the fact that individuals generally prefer to receive reductions in prices now than in the future. We will use the Treasury social discount rate of 3.5% to discount future impact to calculate present values. We will calculate the present value both over 30 years (to reflect the long term impact of the loss of a comparator) and 5 to 10 years (where impacts are more certain).

Where monetisation is not possible, we will undertake a quantitative or qualitative assessment of the impact on our ability to make comparisons and indicate the severity of the impact. Qualitative assessments are more likely in some areas than others, for example where we make more qualitative uses of comparisons. For

example it might not be possible to monetise the impact under criterion 5 (the loss of a comparator with important differences or similarities), however we would expect to monetise most but possibly not all the impacts under criterion 3 (impact on benchmarks).

When assessing impacts we will take into account the certainty around whether the impacts would occur, for example through changes in regulation, for example by including ranges around impacts.

A1.3.2 Our assessment on whether the merger is likely to prejudice our ability to make comparisons

Our assessment of whether a merger is likely to prejudice our ability to make comparisons will be based on an overall assessment, taking into account both monetised and non-monetised impacts. In particular we will first consider the monetised impacts, taking into account the certainty that they will occur, and then consider whether the non-monetised impacts would change the balance of the decision. When making this decision we will be conscious that the CMA has the ability to make a more detailed investigation with a Phase 2 reference and so we would want to be reasonably certain that a merger would not prejudice our ability to make comparisons.

A1.4 Criteria for assessing relevant customer benefits

We will evaluate the evidence put forward by merger parties on relevant customer benefits against the following criteria:

Criterion 1: Are there relevant customer benefits?

We will consider whether the proposed benefits meet the test laid out in the Water Industry Act 1991 (as amended by the Water Act 2014). That is does the proposed merger lead to:

- lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom; or
- greater innovation in relation to such goods or services;

for customers, including future customers, at any point in the chain of production and distribution (not just final consumers).

Criterion 2: How likely or certain are the benefits to be achieved?

Not all proposed cost-savings from mergers are achieved and so we will consider how certain the relevant customer benefits are to be achieved. All else equal, benefits which are more likely accrue to customers, for example licence modifications to allow immediate reductions in price limits or improvements in outcome commitments, will be more likely to be considered to be relevant ones.

We will also consider how easy is it to monitor that the benefits are actually achieved. The more difficult it is for companies to demonstrate compliance with the delivery of the benefits and/or the more difficult it is for us to monitor that the benefits have been secured, the less likely we will be of the opinion that benefits should be considered relevant customer benefits.

Criterion 3: Are the benefits merger specific?

We will consider whether the benefits are unlikely to accrue without the merger. Only benefits which are unlikely to accrue without the merger will be Relevant Customer Benefits. Relevant customer benefits are only considered if we identify a prejudice to our ability to make comparisons.

Criterion 4: Are the benefits expected to accrue within a reasonable time period of the merger?

Benefits which will accrue immediately (or at least in the short term) and which are easy to secure, for example result from immediate changes to licences, are more likely to be considered relevant customer benefits. While the time period that we might expect benefits will vary from case to case, we would generally expect benefits to start to accrue within 1 to 2 years of the merger.

Criterion 5: Are the benefits likely to be sustained?

As a part of that assessment, it will be relevant to consider how sustainable the benefits are. Relevant customer benefits which are not sustained (e.g. one-off reductions in bills or improvements in service which do not continue) are, all else equal, less likely to be found to outweigh the prejudice to our ability to make comparisons arising from the merger (where the impact is likely to be sustained over future controls periods).

A1.4.1 Weighting of relevant customer benefits

We would expect to weight relevant customer benefits, where possible based on their monetised impacts. We will discount future monetised impacts based on the Treasury Green Book social discount rate of 3.5%. Where monetised impacts are not possible we will consider quantitative and qualitative evidence on relevant customer benefits, taking into account supporting evidence on the potential scale. We will place less weight on relevant customer benefits that are less certain, do not accrue over a reasonable period of time or are less likely to be sustained. We will give less weight to relevant customer benefits that are a long way in the future, for example beyond ten years, due to the potential that these incremental benefits will be eroded by improvements elsewhere in the industry as other water companies catch-up with the performance of the merged entity.

A1.4.2 Determining whether the likely prejudice is outweighed by the relevant customer benefits

When determining whether the prejudice is outweighed by relevant customer benefits we would first consider the monetised impacts. In particular we will consider whether the monetised relevant customer benefits outweigh the likely prejudice, taking into account the certainty around potential impacts. After considering the monetised impacts we will consider whether, in the round the non-monetised impacts would change the balance of the decision. When undertaking this assessment we will be conscious that, the CMA can exercise discretion if it decides not to refer the merger in question for a phase 2 investigation. In exercising that discretion, the CMA would consider the benefits of a CMA phase 2 investigation, including the possibility of remedies being obtained that seek to preserve any relevant customer benefits.⁷⁵ We will therefore need compelling evidence that customer benefits outweigh the likely prejudice from the impact of the merger on our ability to make comparisons.⁷⁶ When undertaking this assessment we will be mindful that merger-specific relevant customer benefits might be short lived (and therefore of lower value) as they could be eroded by underlying efficiency improvements created by the regulatory framework.

⁷⁵ This paragraph mirrors paragraph 4.5 of the CMA's 'Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance'. See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284397/oft1122.pdf . At phase one, only undertakings are considered whereas the CMA has order making powers, and hence potentially more flexibility in remedy design, at phase two.

⁷⁶ Office of Fair Trading (2010), Mergers: exceptions to the duty to refer and undertakings in lieu of a reference

A1.5 Company evidence

We will expect companies to submit evidence on the impact of the merger on both our ability to make comparisons and relevant customer benefits. When examining the evidence we have received for the assessment of a merger we will place the greatest weight on assessments which are complete, robust, certain, clear and independently assured, and specifically on benefits with evidence of customer support.

We will evaluate evidence on both prejudice and relevant customer benefits based the criteria below:

Criterion 1: Clarity and transparency around approach and assumptions

Submissions by the merger parties should clearly present the results and conclusions of any analysis undertaken as well as the methodology used, any assumptions made, the justification for the methodology and the robustness of the results to any assumptions made. For example any estimated impacts of the merger on our ability to make comparisons should be submitted with a practical explanation of how the characteristics of the two merger parties affect this impact. This explanation might consider relevant differences between the two parties, such as the environmental conditions in which they operate or the different customer bases served.

Criterion 2: Completeness of the description of the analysis

Submissions should contain a complete description of any analysis undertaken. Relevant assumptions should be discussed and choice of any valuation techniques explained. We should be able to fully understand the results and also any modelling behind them, without having to seek more information from the submitting party.

Criterion 3: Ability of Ofwat to replicate results

We should be able to replicate the results of analysis that has been submitted. This means that merger parties should be prepared to respond promptly to a request, at very short notice, for all relevant information, models and supporting data necessary for us to reproduce the results presented in the parties' submissions.

Criterion 4: Robustness and independent assurance,

We expect evidence to be robust. We will have more confidence in analysis which uses sensitivity analysis to demonstrate the robustness of its impacts. Similarly we

will also have more confidence if both the methodology employed and the results of applying that methodology have been subject to expert review in relevant fields. The degree of independent assurance merger parties wish to provide is a matter for those parties. However we will adopt a proportionate approach and would expect evidence which is significant to the merger parties' case may require a higher degree of independent assurance.

Criterion 5: Evidence of customer support

Ofwat has a duty to protect the interests of consumers. As a result, evidence which suggests that customers support the proposed merger, or the proposed benefits from the merger would play an important role in our assessment.

Appendix A2: Examples of comparisons, relevant customer benefits and undertakings

This appendix provides examples of our use of comparators

- to set price limits in PR14 (Table A2.1);
- to incentivise monitor and incentivise service quality (Table A2.2); and
- to monitor, enforce and spread best practice (Table A2.3).

The potential impact on our use of comparators of possible regulatory changes is set out in Table A2.4.

This appendix also provides examples from previous water merger references:

- relevant customer benefits (Table A2.5); and
- remedies imposed or considered (Table A2.6).

Table A2.1 Examples of our use of comparators to set price limits in PR14

Area	How we use comparators
Business planning process	The move to a risk based review with the best business plans qualifying for enhanced status relied extensively on comparisons.
Wholesale cost modelling	As data points in totex models and unit cost models.
Retail average cost to serve	As data points in retail average cost to serve calculation.
Bad debt	In PR14 we compared bad debt claims across companies as well as levels of deprivation.
Pensions	At PR09 we compared pension deficit levels to help us set our policy. We used the same policy at PR14.
Wholesale special cost factor claims	For some claims (for example energy) we made comparisons across the industry to establish if a company was different from others.
Cost allocation	We compared approaches to cost allocation between wholesale and retail and household and non-households to highlight areas where companies are not following guidelines.

Area	How we use comparators
PAYG and RCV run-off	We compared PAYG and RCV run-off rates to identify whether to challenge company proposals.
Accounting policies and assumptions	For PR14 we compared the accounting treatments across companies for example on Infrastructure Renewals Expenditure under IFRS accounting standards.
Tax allowances	We compared the tax treatment of capital expenditure across the industry to allow us to challenge companies that appeared to be in a different position.
Cost of capital	We compared actual gearing levels across companies to inform our notional gearing structure, we also compared debt costs across companies to corporate benchmarks
Credit rating	We compared target credit ratings and forecast financial ratios across companies to identify whether there were any financeability issues.

Table A2.2 Examples of our use of comparators to monitor and incentivise service quality

Area	How Ofwat uses comparators
Outcome Delivery Incentives (ODIs) and Performance commitments (PCs)	<p>Companies proposed ODIs and PCs across a wide range of areas, some of which were company-specific and some of which were common across the industry. Those ODIs and PCs which were common across the industry were assessed through comparative analysis. For five ODIs (supply interruptions; water quality customer contacts, water quality standards, sewerage pollution incidents; and internal sewer flooding) we used comparative assessment to identify upper quartile performance commitments and to intervene to ensure that companies were only able to access rewards for genuinely stretching performance. Our assessment of company specific ODIs was informed by comparisons to similar ODIs proposed by other companies and/or historic performance data (where available).</p> <p>We also used cross company comparisons to identify gaps where we intervened to introduce additional ODIs.</p> <p>We assessed performance commitments proposed by companies as a part of the risk based review. Scoring criteria included an assessment of the value for money of the performance commitments proposed, justification of the level of the performance commitment and the processes and procedures for</p>

Area	How Ofwat uses comparators
	measuring, reporting and governance of the performance commitments. Companies with a score of more evidence required or significantly more evidence required for criteria assessed in the risk based review of company business plans were able to learn from the best practice approaches adopted by those companies scored as exceptional.
Service Incentive Mechanism (SIM)	All companies have the SIM as an outcome incentive (for retail). The SIM comprises quantitative and qualitative components which measure customers' overall satisfaction with the service levels they receive from companies. Under this mechanism companies are rewarded or penalised financially for their performance relative to the rest of the industry. Comparisons are therefore critical to the operation of the SIM. ⁷⁷
Company performance measures	We monitor and publish comparative company performance against a range of customer experience, environmental and reliability and availability performance measures. Company performance is assessed on a red, amber green scale depending whether expectations are met, and identifies companies which raise concerns.

Table A2.3 Examples of our use of comparators to monitor, enforce and spread best practice

Area	How Ofwat uses comparators
Customer issues	
Customer Engagement	Compared proposals across companies to identify best practice and encouraged other companies to adopt. As part of PR14, we assessed the information companies had provided on customer engagement and willingness to pay. In some cases, companies that received a score of more evidence required or significantly more evidence required were able to learn from the best practice approaches adopted by the companies rated as exceptional.

⁷⁷ At PR14 we used SIM scores from 2011-14 (i.e. a three year period) to determine industry average performance, to which each company was then compared.

Area	How Ofwat uses comparators
Codes of practice and compensation schemes	When companies publish these documents it drives reputational incentives to be at least as good as their peers.
Social tariffs and affordability measures	We compared proposals across companies to identify best practice and encouraged other companies to adopt (including affordability measures as part of PR14).
Tariff structures and innovation	In the past we have used comparative cost information to derive tariff policies (especially on more innovative tariffs). We have moved away from detailed scrutiny of charges schemes, companies have to assure us their tariffs comply with our policies; as a result of our assessment of companies' charges for 2015-16, companies were allocated to three assurance categories according to the issues identified with the information provided.
Company behaviour and operating practices	
Board leadership, transparency and governance	We compare performance across companies which feeds into our view of overall company performance and management capability (and was also used as part of PR14).
Approach and response to consultations, including proposals for future regulation and market reform	We get a wide selection of viewpoints and contributions from different, independent, management styles and approaches that contribute to the development of policy.
Compliance with market rules	We compare across companies to identify companies which need additional input.
Challenge in the case of Interim Determination of K (IDoK) claims	We have made use of industry comparisons to challenge the costs submitted and the companies' approach (including management practices) to incurring the costs.
Innovation	By identifying new approaches and ideas (e.g. responding creatively to new requirements) we may be able to identify which companies have been innovative.
Accounting and reporting of data	
Assurance in respect of information	We compare level and nature of assurance

Area	How Ofwat uses comparators
provided to us	provided by companies and challenge companies with least assurance; companies are graded into one of three categories which affects the expectations we place on them in respect of the assurance required on information reported to us under our Assurance Framework. This formed part of PR14.
Transparency and approach to reporting	We have compared across companies to highlight best practice and encourage others to adopt it. Also part of PR14 we expected companies to be transparent about their business plans and established a high bar in respect of the publication of information that was used in making our decisions in the price review. In some instances, we made use of comparisons where companies set out that publication of a specific piece of information might seriously or prejudicially affect their interests.
Financial metrics and credit rating	On-going monitoring of credit ratings and key financial metrics based on actual company structure (collected as part of company performance measures).

Table A2.4 Potential impact on our use of comparators of possible regulatory changes

Regulatory change	Impact on our use of comparators
Continuation of key elements of PR14 methodology	
Wholesale costs	Water sector comparisons are likely to continue to be important for assessing wholesale costs. While it might be expected that water companies would converge to the frontier over time, this has not been the case for water sector costs so far, although efficiency improvements have reduced since the early price controls. Convergence to the frontier might reduce if more focused wholesale controls are introduced, which will lead to improved understanding of the costs associated with the delivery of individual services and allow more specific efficiency challenges to be set (see below).
Retail cost to serve	In PR14 we set the retail efficiency challenge based on average costs to serve, however we said that this was part of an evolutionary

Regulatory change	Impact on our use of comparators
	<p>approach and we hope to move to an efficient cost to serve over future price controls.⁷⁸In the PR14 methodology impact assessment we assumed that companies would eliminate 75% of the difference between their cost and that of the most efficient company within 20 years.⁷⁹ This implies a move towards upper quartile and then potentially frontier efficiency benchmarking over time.</p>
<p>Outcome delivery incentives</p>	<p>In PR14 we used comparators to set our performance requirements in our horizontal ODIs. In our work on the company specific uplift we stated that "...by the middle of the 2015-20 period we expect all companies to reach current upper quartile performance. Consequently it is unclear on what basis we would set any horizontal ODIs for subsequent control periods at the start of the next period..."⁸⁰ Horizontal ODIs were an important development as part of this price control and so our use of them is likely to continue, however our approach is likely to change. For example we could set a dynamic upper quartile target for service and efficiency.⁸¹</p>
<p>Service Incentive Mechanism</p>	<p>Comparative performance measures such as the SIM are good at continuing to drive improvements in less well performing companies. However they are less good at driving improvements to the frontier.⁸² While we stated that we considered the SIM was appropriate to drive improvements for 2015 onwards.⁸³ We have also stated that water companies are unlikely to provide as much value as retail comparators beyond 2015-20 as Ofwat could offset the loss of a water company benchmark by greater reference to other sectors.⁸⁴ In our work on the company specific uplift we assumed that there would be no benefits from SIM beyond 2025 as it would be speculative to make assumption on what might replace the SIM. We continue to consider that this is a reasonable assumption.</p>

Regulatory changes that will impact between 2015-20

⁷⁸ Page 97, Ofwat (2013), Setting price controls for 2015-20 – final methodology and expectations for companies business plans.

⁷⁹ Page 43, PwC (2013), Updated price limits impact assessment.

⁸⁰ Page 44, Ofwat (2014) Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift to the cost of capital.

⁸¹ Uncharted waters: A forward look at managing change in the water sector, Jonson Cox, March 2015.

⁸² Page 13, service incentive mechanism (SIM) for 2015 onwards – a consultation

⁸³ Page 3, Service incentive mechanism (SIM) for 2015 onwards - conclusions

⁸⁴ Page 35, Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital.

Regulatory change	Impact on our use of comparators
Non-household retail competition (from 2017)	Effective competition would remove the need to use comparisons to assess non-household retail costs and other elements of the non-household control. While competition is developing there is likely to be a continuing need for reporting, transparency and monitoring. Hence the focus of comparisons would move from an ex-ante to ex-post basis. If competition develops sufficiently it may be possible to remove regulatory reporting requirements and monitoring.
Abstraction incentive mechanism	The objective of the abstraction incentive mechanism will be to incentivise companies to reduce abstractions at low flows at environmentally sensitive sites compared to baseline historic levels. It is expected that the abstraction incentive mechanism will be introduced in 2015 ⁸⁵ as a reputational incentive based on a ranking in a league table. ⁸⁶ This will introduce an additional area of comparison going forwards.
Network plus non-binding sub-limits (from 2015-20)	As set out in the PR14 methodology impact assessment when describing the move to split wholesale and retail controls, we expect the introduction of separate controls to encourage efficiency by improving transparency of costs and revenues. ⁸⁷ Consequently if network plus sub-limits were used for subsequent controls then the importance of water sector comparators in wholesale cost assessment, could if anything, increase. However a move to more focused controls could lead to better specified models, and therefore more robust results, which might reduce the reliance on individual comparators (although this seems less likely for sewerage where it was not possible to specify a robust full totex model). The impact of network plus sub-limits on the use of comparators is therefore unclear.
Potential longer term regulatory changes	
Upstream competition (feasible from 2019)	The introduction of upstream competition could allow individual parts of the upstream value chain, for example sludge, to be subject to competition. The introduction of competition in specific areas could require the allocation of the RCV across the value chain. While competition would provide a greater customer focus on price and service, this could increase the need for ex-post comparisons and monitoring in the short term as competition developed (to ensure that customers were being protected). However over the longer term the

⁸⁵ Page 29, Setting price controls for 2015-20 – policy and information notice

⁸⁶ Page 25, Setting price controls for 2015-20 – final methodology and expectations for companies business plans.

⁸⁷ Page 6, PwC (2013) Updated price limits impact assessment.

Regulatory change	Impact on our use of comparators
	introduction of competition, when sufficiently developed, could reduce the need for comparators.
Binding service level sub-limits (future price controls)	The impact of binding sub-limits is likely to be similar to network plus non binding sub-limits, although the introduction of binding sub-limits would if anything increase the need for robust models.

Table A2.5: Types of benefits identified in past water merger references

Merging Firms	Year	Potential benefits from merger
South Staffordshire; Cambridge	2012	<ul style="list-style-type: none"> Operating cost savings, primarily at Cambridge
South East; Mid Kent	2006	<ul style="list-style-type: none"> Reduced pumping costs from proposed interconnections Sale or lease of newly redundant office space Improved planning of water resources enabling postponement of investment projects
Vivendi; Southern	2002	<ul style="list-style-type: none"> Access to expertise and worldwide experience of Vivendi group Ability to pool and share best practice Improved management of water resources, and hence in security of supply Some cost savings (though not specified) Better retention and morale of Southern staff, due to improved career prospects
SAUR; Mid Kent; General Utilities	1997	<ul style="list-style-type: none"> Alleviate Water resource imbalance Integrated supply network which would optimize water resource usage and improve security of supply Long-term resource planning Leakage reduction and metering Generation of additional water resources Resource management and water conservation programme

Merging Firms	Year	Potential benefits from merger
		<ul style="list-style-type: none"> • Deferment of need for major new resource development • Efficiency gains relating to head office costs and savings on infrastructure development • Improved service standards • Creation of better circumstances for genuine competition in the region
Wessex; South West	1996	<ul style="list-style-type: none"> • Cost savings in the South West Water Services (SWWS) region • The creation of a strong regional company and increased opportunities for employees of the merged entity • Improved customer service and increased confidence by SWWS customers in their water and sewerage service • The flexible use of Wimbleball reservoir, the linking of Wessex Water Services (WWS) and SWWS trunk mains and the completion of SWWS's water grid • Improvements in water quality in the SWWS region and improved sewage treatment • The removal of planning embargoes and the greater use of local contractors in the SWWS area • Price reductions for water and sewerage services to SWWS's customers
Severn Trent; South West	1996	<ul style="list-style-type: none"> • Cost savings and an improvement in SWWS's operating efficiency, leading to price reductions in water and sewerage services for SWWS customers • Radical transformation of SWWS's management, leading to the restoration of trust in drinking water quality and the improved management of water supplies • Introduction of a more effective sewage treatment programme • Increased responsiveness to customer needs • Strengthening of the water supply grid • More effective and accelerated investment programme

Merging Firms	Year	Potential benefits from merger
Lyonnaise des Eaux; Northumbrian	1995	<ul style="list-style-type: none"> • Direct savings due to rationalisation of head office and technical management functions
Colne Valley; Lee Valley; Rickmansworth	1990	<ul style="list-style-type: none"> • Operational cost savings, mainly on staff costs • Interest savings as a result of improved cash flows and ability to achieve more favourable finance terms • One off benefits from sales of surplus properties • Benefits from cancellation and deferral of capital projects
Southern Water; Mid Sussex Water	1990	<p>Opportunities for reducing duplication of effort in:</p> <ul style="list-style-type: none"> • Customer Billing • Telemetry • Engineering Design • Training • Digital Mapping • Legal Expertise
General Utilities/Mid Kent	1990	<ul style="list-style-type: none"> • Access by Mid Kent Water to water technology and know-how • Access to French water industry's extensive water industry research on an arms-length basis, enabling more effective and cost-efficient solutions to problems to be achieved • Facilitate opportunities for further informal exchanges on technical matters

Table A2.6: Remedies imposed/considered in previous water merger references

Merging Firms	Year	Remedies or undertakings imposed/considered
Post Enterprise Act cases		
South Staffordshire; Cambridge	2012	<ul style="list-style-type: none"> No prejudice was found in this case and so remedies were not considered
South East; Mid Kent	2006	<ul style="list-style-type: none"> One-off rebate of £4 million distributed between customers An efficiency adjustment of £3.1m annual operating expenditure savings (equal to the value of merger synergies specified by merging firms) was required as part of PR09 Divestiture of one company was also considered but found disproportionate to the prejudice resulting from the merger
Pre-Enterprise Act cases (final decision by Secretary of State (SoS))		
Vivendi; Southern⁸⁸	2002	<ul style="list-style-type: none"> Undertakings offered by Vivendi to Ofwat:⁸⁹ <ol style="list-style-type: none"> Establish a new comparator in the form of separate business unit for Hampshire and the Isle of Wight under a separate license granted by Ofwat, and Commitment to sell interest in Bristol Water Under these proposals the merger of Folkestone and Dover (F&D) with Southern Water would also have been subject to a phase two reference and investigation. Prior to a phase two reference, the minority interest (24.6%) in Bristol Water was sold. At phase two the panel found that a prohibition would be disproportionate to the detriment found. A less intrusive remedy considered was divestment of Three Valleys, by far the largest of Vivendi's three majority owned WoCs but this was also found

⁸⁸ This merger would have brought together Southern Water (a WaSC) and a variety of WoCs: Three Valleys Water; Folkestone and Dover (F&D) Water; Tendring Hundred Water; a 24.6% minority stake in Bristol Water and a 31.4% minority stake in South Staffordshire Water.

⁸⁹ See http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/472a3.13.pdf

Merging Firms	Year	Remedies or undertakings imposed/considered
		<p>disproportionate by a majority of the panel since there was no prejudice on the Sewerage side. F&D or Tendring Hundred were deemed too small for a divestment to be relevant in the context of the loss of the much larger Southern's independence. The divestment of F&D also had the disadvantage that it would involve the loss of relevant benefits from bringing southern and F&D under common control.</p> <p>Four of the phase 2 panel found that divestment of the minority stake in South Staffordshire Water would be sufficient. However one member of the panel, and subsequently the Secretary of State (SoS), believed that a more intrusive remedy was required – that Vivendi should also be required to sell Three Valleys Water.</p>
SAUR; Mid Kent; General Utilities	1997	<ul style="list-style-type: none"> General Utilities (GU) and SAUR Water plc, owner of South East Water, bid for Mid Kent. Proposed merger was prohibited.
Severn Trent or Wessex and South West	1996	<ul style="list-style-type: none"> This merger case considered competing bids by two WaSCs Severn Trent plc and Wessex Water plc for a third WaSC, South West Water. Both bids were prohibited on the basis that no remedy would be sufficient to remedy loss of comparator
Lyonnaise des Eaux; Northumbrian⁹⁰	1995	<ul style="list-style-type: none"> A phase two investigation recommended that the bid should be allowed if substantial price reductions were agreed, sufficient to move the merged company to the efficiency frontier. The SoS permitted the merger on the basis that prices to water customers of the merging companies would be reduced by 15 per cent over the following six years.
Colne Valley; Lee Valley; Rickmansworth	1990	<ul style="list-style-type: none"> Merged company was required to co-operate fully with DGWS for setting of new efficiency factor Savings resulting from the merger were to be "wholly" applied to users. Merged company had to agree that for ten years after the merger no class of customer would be

⁹⁰ Lyonnaise owned North East Water Ltd, a WoC which it wished to merge with a neighbouring WaSC, Northumbrian under a single appointment and thereby achieve significant cost savings

Merging Firms	Year	Remedies or undertakings imposed/considered
		<p>charged more than they would have been if the merger had not taken place</p> <ul style="list-style-type: none"> The merging companies had to continue as separate profit centres and information on those profit centres had to be available for the DGWS as required
Southern Water; Mid Sussex Water	1990	<ul style="list-style-type: none"> Merger allowed with no remedies.
General Utilities/Mid Kent	1990	<p>General Utilities and Parent company CGE were required to undertake to:</p> <ul style="list-style-type: none"> Have no involvement in management of the merging companies, including having no access to financial or commercial information from Mid Kent Holdings or Mid Kent Water which could be relevant to the DGWS's functions in relation to Mid Kent Water Not be represented on the board of Mid Kent Water or Mid Kent Holdings Not use its power to block special resolutions of Mid Kent Holdings <p>Alternately GU required to divest holding to level "at which it would not have the ability materially to influence policy".</p>

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.



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