CMA’s approach to mergers in the water sector

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Outline

- Background to legislative reform
- Key aspects of process and procedure
  - Legal regime for water mergers
  - Working arrangements between Ofwat and CMA
- Substantive economic assessment
Background to reform

- Activities of water undertakings regulated by Ofwat via comparative regulation
- Mergers between water undertakings reviewed under special merger regime designed to prevent prejudice to Ofwat’s ability make comparisons
- Prior to Water Act 2014 regime meant virtually all mergers between water undertakers had to undergo detailed Phase 2 investigation
- Now mergers between water undertakings can be reviewed, cleared or remedied at Phase 1
- First Phase 1 special merger review currently in progress
Legal regime

- Jurisdiction
- Legal test
- Standard of proof
- Role of Ofwat
- Relevant Customer Benefits and Undertakings in Lieu
Legal regime

Jurisdiction: Merger of two or more water enterprises

- Water enterprise is a company appointed to be a WASC or a WOC (i.e., holding the relevant licence)
- Both or at least two parties will need to be water enterprises
- If only one party is a water enterprise, the transaction will be assessed under the EA02 and follow the general merger regime
- Question regarding water mergers involving aspects of the market that are not subject to regulation, or have some degree of competition
  - CMA will consider on a case by case basis with view to assessing whether merger gives rise to concerns under the most appropriate regime for that assessment
  - In principle, can have both general merger review and special merger review concurrently
Legal regime

- **Legal test**
  - Question for CMA: Whether water merger has, or is likely to prejudice Ofwat’s ability in carrying out its functions to use comparative regulation
  - Question broken down into a consideration of the impact of the merger across a number of areas in the context of how Ofwat carries out its functions
  - A judgment on prejudice is required across each and all of these - one cannot be weighed against the other
  - An adverse impact may not amount to prejudice if insignificant

- **Standard of proof**
  - Phase 1: low threshold – realistic prospect
  - Phase 2: higher threshold - balance of probabilities
Legal regime

Role of Ofwat

- Ofwat has a statutory role in Phase 1
- Before forming a view the CMA must request and consider Ofwat’s opinion prejudice, relevant customer benefits and undertakings in lieu
- No statutory role at Phase 2 but co-operation likely to continue
Legal regime

- **RCBs and UILs**
  - Only relevant if the CMA has concluded that there may be prejudice
  - RCBs cannot only be targeted at merging parties customers – prejudice goes to Ofwat’s ability to regulate overall
  - At Phase 1 cannot have both RCBs and UILs
  - At Phase 1 UILs have to be clear cut and capable of ready implementation – however, behavioural undertakings through licence modifications are possible
  - In context of Phase 1 timing, early engagement with Ofwat and CMA is essential
Working with Ofwat

- General merger regime
  - Although it has no formal role under general merger regime, Ofwat can still have a key role as a well informed third party in areas related to water where special merger regime will not apply.

- Special merger regime
  - 2 key documents outline cooperation in process: Ofwat’s Statement of Intent and CMA Guidance on Water Mergers.
  - Ofwat now has a statutory role in Phase 1 but not Phase 2 – in practice cooperation is likely to continue.
  - More generally the CMA and Ofwat are both eager to foster early and open cooperation – particularly in pre-notification.
Substantive assessment

- Phase 1 v Phase 2
- Key principles
- Key issues for analysis
- Areas of assessment – what might be affected by the merger?
- Application in Pennon/Bournemouth
- General merger regime
Phase 1 v Phase 2

- Principles and key issues for economic analysis are the same
- In practice submissions for the purposes of assessment likely to be the same
- Key differences arise as a result of different standard of proof and timing considerations
- CMA assessment of Parties’ submissions may be more guided by initial Ofwat view of transaction
- Where no disagreement between Parties and Ofwat, CMA may consider whether assumptions and submissions reasonable in the context of framework for assessment and third party consultation
- Where there is disagreement between Ofwat, the Parties and any third Parties, these may be more difficult to resolve in the context of timing and relevant legal test at Phase 1
Key principles

- Monopoly regulation of core networks
- Ofwat needs a way of estimating efficient costs and comparing performance between companies
- Merger leads to a loss of information for Ofwat – fewer independent comparators
- How significant is this loss of information in any particular case?
Key issues for the analysis

- Whether the merger involves the loss of an independent comparator
- Extent to which the merger will change benchmarks
- Number and quality of independent observations that remain
- Whether the merger leads to the loss of a company with important similarities or differences for comparisons
- Whether Ofwat could amend its approach to reduce the impact of the loss of a comparator
Areas for assessment

- Benchmarking of costs in the price control
  - Impact on econometric models and other cost modelling
  - Broader effects on Ofwat’s analysis – e.g. assessment of business plans
- Monitoring and incentivising service quality
- Ongoing regulation and spreading best practice
Pennon/Bournemouth

- Phase 2 investigation – June-Nov 2015
- First special merger regime merger investigation since PR14
- Last merger under the compulsory reference regime
- WaSC-WoC merger
How did we analyse merger impacts?

- Extent to which the merger will change benchmarks

- Number and quality of independent observations that remain

- Whether the merger leads to the loss of a company with important similarities or differences for comparisons

- Whether Ofwat could amend its approach to reduce the impact of the loss of a comparator

- Wholesale cost benchmarking

- Retail costs

- ODI and SIM

- Precision of Ofwat’s models

- Consideration of broader qualitative impacts

- Consideration of flexibility in regulatory approach
Overall findings

- Merger likely to have small negative impact on wholesale cost benchmark
- Small impact on precision, but unlikely to undermine Ofwat’s ability to use its models
- Negative impact on two ODI targets and SIM benchmarks, but mitigating factors
- Overall, we concluded that the adverse impacts were not significant enough to amount to prejudice to Ofwat’s ability to make comparisons
Mergers in areas open to competition/non-water mergers

- One recent example – Severn Trent/ United Utilities non-household retail JV (CMA decision May 2016)
- Standard merger review focused on determining substantial lessening of competition
- Main challenge for analysis – trying to predict merger impacts in market not yet open to competition/early stages
Reflections?
References

- CMA Guidance on water mergers
- Ofwat Statement of Intent
- Ofwat Statement of Methods
- CMA decision in Pennon/Bournemouth