

# **CMA's approach to mergers in the water sector**

**Sheldon Mills, Senior Director - Mergers**  
**Chris Jenkins, Economics Director**

**21 November 2016**

# 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**

- **Jurisdiction: Merger of two or more water enterprises**
  - Water enterprise is a company appointed to be a WASC or a WOC (ie holding the relevant licence)
  - Both or at least two parties will need to be water enterprises
  - If only one party is a water enterprise - 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 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 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

## ● 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

## ● 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 →
  - Wholesale cost benchmarking
  - Retail costs
  - ODI and SIM
- Number and quality of independent observations that remain →
  - Precision of Ofwat's models
- Whether the merger leads to the loss of a company with important similarities or differences for comparisons →
  - Consideration of broader qualitative impacts
- Whether Ofwat could amend its approach to reduce the impact of the loss of a comparator →
  - 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

# General merger regime

- **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**