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Trust in water

Ofwat's response to the mergers remedy review

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Background

As each of the water companies in England and Wales is effectively a regional monopoly, we use comparative information from companies to:

- ensure that customers are paying a fair price for their water;
- identify good performance; and
- set incentives for companies to improve.

If two water companies merge with each other, this might make it harder for us ('prejudice our ability') to carry out these functions. So, a special merger regime applies within the water sector in England and Wales.

The special merger regime applies when two or more water enterprises (each with a turnover that exceeds £10 million) merge, or seek to merge, with each other, i.e. come under common ownership or control. The special merger regime does not apply to transactions involving water supply licensees (or between a water company and a water supply licensee), which are covered by the general merger regime.

The special merger regime was amended by the Water Act 2014. This required us to publish a [statement of methods](#) that we will apply in assessing future transactions. The changes brought about by the Water Act 2014 require us to give an opinion to the Competition and Markets Authority (CMA) as to the merger impacts in phase 1 of a merger investigation.

CMA review of 5 merger remedies in the regulated water sector

The CMA plans to review five water merger remedies put in place before 1 December 2007. This comprises:

- (a) General Utilities plc/The Mid Kent Water Company, 1990: The undertakings given to the Secretary of State by General Utilities plc dated 21 March 1991.
- (b) Lyonnaise des Eaux SA/Northumbrian Water Group plc: The undertakings given to the Secretary of State by Lyonnaise Europe plc dated 23 April 1996.
- (c) General Utilities plc and SAUR Water Services plc/Mid Kent Holdings plc: The undertakings given to the Secretary of State by General Utilities plc dated 21 April 1998 and SAUR Water Services plc dated 8 May 1998.

(d) Vivendi Water UK plc/First Aqua (JVCo) Ltd, 2002: The undertakings given to the Secretary of State by Vivendi Water UK plc and Southern Water Capital Limited 23 April 2003.

(e) South East Water Ltd/Mid Kent Water Ltd: The undertakings given by Utilities Trust of Australia and Hastings Diversified Utilities Fund, and by South East Water Ltd and Mid Kent Water Ltd, on 29 November 2007.

The CMA has asked for views from interested parties on whether there is a case for removing or varying these undertakings.

General Utilities plc/The Mid Kent Water Company, 1990

We note that at the time of this transaction, the MMC accepted that it was important for Mid Kent Water to remain independent for the purpose of enabling the Director General of Water Services (now Ofwat) to make comparisons for the purposes of our regulatory framework, which led to the undertakings given by General Utilities.

Since then, there have been a number of changes in the ownership of the companies concerned. Most notably, the Competition Commission allowed a transaction in 2006-07 which led to Ofwat modifying water company licences to combine Mid Kent Water and South East Water into a single appointed water company, removing Mid Kent Water as an independent comparator and which these undertakings were intended to preserve. We therefore agree that there has been a relevant change of circumstances and that these undertakings should be released.

Lyonnaise des Eaux SA/Northumbrian Water Group plc

In 1995, Lyonnaise des Eaux ("Lyonnaise"), who owned North East Water, announced its intention to acquire Northumbrian Water Group in order to merge the two companies. We said at the time that the loss of Northumbrian Water as a separate comparator would significantly weaken the effectiveness of our regulatory regime.

The MMC agreed with us, and agreed that the prejudice would be remedied by Lyonnaise reducing charges for customers (with the merged company at or close to the efficiency frontier for the sector). This would benefit both customers in the North East (through direct savings) and across England and Wales (with fewer comparators being countered by a new frontier comparator). We agreed this was the best long-term outcome for customers.

The undertakings included additional conditions to protect customers and measures to ensure that Lyonnaise was listed on the London Stock Exchange by 2005.

The CMA notes that there have been changes in circumstance concerning the undertakings. We support their removal for the following reasons.

First, the time limited requirements have all passed with charge adjustments ending in 2000, revenue adjustments in 2002, and the company becoming listed in 2003. Subsequent price reviews for the combined group have ensured ongoing protection for customers and our regulatory model has evolved considerably.

We would also note that the MMC considered that Ofwat was best placed to calculate what would be needed to achieve “frontier” efficiencies – with significant price reductions from 1996. This was achieved in the 1999 price review, with bill reductions of about 17% in real terms between 1999-00 and 2000-01. At our last price review in 2014, Northumbrian Water proposed expenditure that was more efficient than our calculated (upper quartile) baseline, suggesting that the merged company continues to have a positive effect for all customers through our comparative regulation.

Finally, Lyonnaise no longer holds any shares in Northumbrian Water. The CMA has noted the sale of 75% of NWG in 2003, but CKI then acquired Northumbrian Water Group in 2011 (and are the current owners).

General Utilities plc and SAUR Water Services plc/Mid Kent Holdings plc

We note that in 1995, both General Utilities, who owned South East Water, and SAUR Water Services, who owned Folkestone and Dover Water Services, had interests in a variety of regulated water companies. In a joint venture, both companies had the intent to acquire Mid Kent Holdings. They planned to divide Mid Kent Water's operational area with the western half merging with South East Water and the eastern half merging with Folkestone and Dover Water Services.

In 1996, the majority of the water company market was occupied by four main companies. But Mid Kent Holdings was an independent water company. We estimated that the loss of an independent company would limit our ability to compare water companies, we believed that a price reduction for consumers would correct this fault. Instead, MMC prohibited the merger citing unsustainable long-term benefits and permanent damage to the comparator regime.

In 2006-07, Mid Kent Water and South East water were combined into a single appointed water company. Because South East Water is no longer a distinct company, there has been a relevant change in circumstance. We no longer consider

that there is an ongoing impact on our ability to make comparisons between water companies and therefore would support the CMA removing this undertaking.

Vivendi Water UK plc/First Aqua (JVCo) Ltd, 2002

In 2002, it was proposed that Vivendi Water, now known as Veolia Water UK, would acquire Southern Water from First Aqua. If this was to go ahead, Vivendi Water would have owned a total of four water only companies, with two of the providers situated in the south east of England, Southern Water and Folkestone and Dover Water Company.

Since these undertakings were given, there have been significant changes to the structure of the water market. Vivendi, now part of the Veolia Environnement group of companies, no longer has any interest in Southern Water Investments Limited and has reduced its investment in the water sector in recent years. Southern Water Services Limited is now owned by a separate company, Greensands Holding.

We agree with the CMA that the changes to the water market represent a relevant change of circumstance and, therefore, the undertakings are no longer appropriate. Since Vivendi are no longer active in the running of Southern Water Services, we would agree with releasing them from their previous obligations towards Southern Water Services.

South East Water Ltd/Mid Kent Water Ltd

We note the Competition Commission concluded that, although the intended acquisition of South East Water by the owners of Mid Kent Water would prejudice our ability to make comparisons under our regulatory regime, the negative effect of the merger could be limited through a number of one off price reductions.

The CC concluded that an effective remedy would be a one-off price reduction to all customers of South East Water and Mid Kent Water of £4 million. Additionally, the expected efficiency savings would be factored into the 2009 price determination. This was calculated to be £3.1 million.

As the undertakings concern a one-off price reduction in 2008 and efficiency savings which led to an opex reduction in the 2009 price review, we would support their removal. As noted elsewhere, the underlying Appointments of the two companies concerned have since been combined.

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 trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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