



Europe Economics Executive Brief

Water Mergers – The New Regime

A new regime for water mergers came into force from 29 December 2004, following amendments to the Water Industry Act 1991 (WIA). The publication of final guidelines by the Competition Commission¹ gives useful insights into the approach that may be taken in future water merger references.

Introduction

Under the new regime, all mergers between water companies having UK turnover of over £10m will be subject to a mandatory reference by the OFT to the Competition Commission (hereafter referred to as the Commission).

In place of the previous public interest test, the Commission must now focus specifically on whether a relevant merger situation has been created, and if so whether the merger prejudices the ability of the Director General of Water Services (DGWS) to make comparisons between different water enterprises. This is in contrast to the “substantial lessening of competition” test that is to be applied to non-water mergers under the Enterprise Act merger regime.

Crucially, in line with the Enterprise Act regime, the Commission’s decision on both the effects of a merger and on any remedies for those effects will now be determinative. By contrast, Vivendi’s proposed acquisition of Southern Water in 2002 ended with Vivendi settling for a minority stake after the Secretary of State did not accept the Commission’s majority recommendations.

European Dimension

The European Commission has exclusive competence to apply the provisions of the EC Merger Regulation (ECMR)² to mergers between

enterprises whose combined turnover exceeds the thresholds specified in the ECMR.

However, Article 21(3) of the ECMR provides that Member States may take appropriate measures to protect “legitimate interests” other than those taken into account by the European Commission. An EC decision of 29 March 1995 in the context of a previous water merger recognised the legitimate interest of the UK in considering regulatory aspects of water mergers.³

The guidelines assume that the decision continues to be applicable. However, given changes to UK legislation this may need to be reaffirmed when the next water merger with a community dimension is proposed. In particular, the European Commission has stated that:⁴

“the [European] Commission’s recognition of the legitimate interest of the United Kingdom applied only to the legislation in force at that time ... the [European] Commission may in future need to look at whether the changes to UK legislation give rise to any material change.”

The EC decision states that *“the minimum number of independent water companies should ... not be higher than necessary to ensure the effective operation of the regulatory regime.”* If the decision still applies, proponents of future water mergers may highlight the question of why a higher number of comparators is needed in the

¹ Competition Commission (2004), “Water Merger References: Competition Commission Guidelines”, Dec

² Council Regulation (EEC) No 4064/89 as amended or Council regulation (EC) No 139/2004 as applicable

³ Lyonnaise des Eaux SA/Northumbrian Water Group, Case No. IV/M.567

⁴ European Commission letter of Dec 29th 2004 in response to consultation on draft guidelines



water sector than in other regulated sectors such as sewerage or electricity distribution.

Impact on Comparisons

The Commission's guidelines highlight three ways in which mergers might affect the value of the DGWS's comparisons:

- The DGWS may have to rely less on efficiency comparisons in setting price controls, potentially leading him to set higher price caps;
- Companies may have reduced efficiency incentives if their price caps are based more on their own costs rather than efficiency comparisons;
- The DWGS may be less able to use comparisons for wider benchmarking purposes.

With regard to the second of these, however, the guidelines themselves state that *"companies' incentive to reduce costs results principally from the price cap being fixed for five years"* – something which would be unaffected by mergers.

Value of comparisons for price-setting

A greater number of comparators increases the statistical robustness of Ofwat's efficiency comparisons. In its recent final price determinations for 2005-10,⁵ Ofwat made explicit adjustments which recognised that less reliance could be placed on comparisons for sewerage, where it has only 10 comparators, than for water, where it has at least 20.

A greater number of independent comparators may also allow Ofwat to identify a more challenging efficiency frontier. In the Vivendi case, Ofwat carried out modelling on this issue which suggested that reducing the number of comparators from 22 to 21 would lead to a loss to customers of £450m on average in present value

terms. However, these results were not endorsed in the Commission's final report.⁶

Company-specific factors

In an important section, the guidelines list a range of factors which may affect the extent of any detriment to Ofwat's comparisons. These include the degree to which the companies are independent before and after the merger and whether the merger would lead to the loss of valuable comparisons between two similar companies or the loss of a company at the efficiency frontier.

The guidelines suggest that mergers which reduce the number of sewerage comparators may be more detrimental than those which only reduce the number of water comparators, given that there are fewer comparators to bring with in the sewerage sector.

Comparative efficiency techniques

A critical issue mentioned in the guidelines is whether the DGWS could *"offset partially or wholly the effects of the merger on his comparisons through developing comparative methods which are less sensitive to the number of comparators than those currently used."*

This was an issue considered in the Vivendi case, where the Commission concluded that Ofwat should begin to collect and use sub-company data for water companies (as it does for sewerage companies) and should test the use of panel data.

Catch-up and frontier shift

It has been suggested in some responses to the Commission's consultation on draft guidelines that more robust comparisons between water companies allow the regulator to set higher "catch-up" factors for inefficient firms, but that this is offset by a lower estimate for ongoing efficiency gains for the industry as a whole ("frontier shift").

The argument is that this occurs because frontier shift can be calculated by subtracting the average

⁵ Ofwat (2004), "Future water and sewerage charges 2005-10; Final determinations", Dec

⁶ Competition Commission (2004), "Vivendi Water UK PLC and First Aqua (JVCo) Limited", Nov



catch-up factor from an estimate of the total scope for industry efficiency improvements.

However, this argument will not always hold true. For example, it would break down if having more management teams competing to be at the frontier led to faster efficiency gains through time and this was reflected in a higher estimate of the total scope for future efficiency improvements.

Remedial Action

If the Commission concludes that a merger may prejudice the ability of the DGWS to make comparisons, it must decide on appropriate remedies.

The Commission would consider whether it should use its powers to make orders or to accept undertakings to remedy the prejudice itself or any adverse effect which might result from the prejudice. In addition, the Commission may decide to make non-binding recommendations on remedial action that might be taken by other parties (e.g. the DGWS or the government).

In deciding on remedies the Commission may take into account whether there are any relevant customer benefits arising from the merger which are substantially more important than the prejudice.

Given the new determinative role of the Commission, companies may expect more detailed discussions with the Commission than before on possible remedies.

Costs and proportionality

The guidelines state that the Commission will take into account the cost of remedies and their proportionality to the prejudice that has been identified.

An exception to this is that the Commission will not normally take into account the costs of divestiture. This is likely to encourage parties considering mergers to make their proposals conditional on approval by the competition authorities.

Types of remedy

The Commission discusses various types of remedy, including structural remedies such as prohibition or divestiture (or partial prohibition or divestiture) and behavioural remedies such as a requirement to maintain separate management or accounting arrangements.

However, the guidelines suggest that, subject to considerations of proportionality, structural remedies are likely to be preferable to behavioural remedies because they address the effect of the merger directly and do not require the same monitoring and enforcement once implemented.

Customer benefits

Relevant customer benefits may take the form of lower prices, higher quality, greater choice or greater innovation. These benefits must accrue to customers of the merging enterprises (not necessarily end consumers) as a result of the merger.

One potential source of benefits is cost savings due to economies of scale. However, whether or not economies of scale exist in the water and sewerage industries is a matter of debate.

A report commissioned by Ofwat⁷ found evidence of *diseconomies* of scale for combined water and sewerage companies and only weak evidence for economies of scale for water only companies.

On the other hand, companies wishing to merge would be able to point to economies of scale in financing, explicitly recognised by Ofwat's use of a small company premium on the cost of capital in its price determinations. Europe Economics has carried out calculations for this executive briefing which suggest that the use of a small company premium increases allowed revenues for all water only companies in aggregate by around £11m per annum.

The guidelines do not explicitly refer to other ways in which mergers might give rise to cost savings, such as from the transfer of best

⁷ Stone and Webster Consultants (2004), "Investigation into evidence for economies of scale in the water and sewerage industry in England and Wales", Jan



practice. However, examples of customer benefits from higher quality are mentioned, such as “improved security of supply due to improved coordination between companies”. It would have to be shown that these benefits could not be obtained without the merger.

Price cut remedies

The guidelines treat reductions in companies’ price caps as a means of bringing forward and increasing the certainty of customer benefits from anticipated cost savings, thus allowing the Commission to place greater weight on proposed benefits.

The Commission states that it will look at the whether or not cost savings are likely to continue beyond the initial five-year period. This suggests that where price reductions are not regarded as being sustainable the Commission is less likely to adopt price cut remedies.

Parallels in the Energy Sector

The regime for electricity distribution mergers is less restrictive than for water mergers. In particular, there is no mandatory requirement for a Competition Commission reference.

Ofgem’s policy on electricity distribution mergers, set out in May 2002,⁸ is to reduce regulated revenue across distribution companies in the merged group by £32m over five years to compensate for the loss of a comparator. This clearly puts a much lower value on comparators than Ofwat has done in the water sector.

The value of regulatory comparisons has recently been examined again by Ofgem as a consequence of NGT’s proposal to sell some of its regional gas distribution networks (DNs). This will lead to the creation of comparators for the first time in the gas distribution sector.

Ofgem’s regulatory impact assessment on DN sales⁹ estimated that the creation of three independent comparators would give rise to customer benefits with a present value of £310m. This is again much lower than the figures Ofwat put forward in the Vivendi case (the figure applies to three comparators rather than one, and additional comparators should be more valuable when there are no comparators to start with).

Unless convincing reasons can be put forward as to why efficiency comparisons are intrinsically more valuable in one sector than the other, these differences suggest that either Ofwat’s past estimates of the value of comparators have been significant over-estimates or that Ofgem is failing to recognise the true value of comparisons.

Conclusion

Under the new regime, the Commission has a determinative role in assessing the effects of water mergers and deciding on remedies. Therefore, the Commission’s guidelines on the approach it will take deserve careful scrutiny. This executive briefing has discussed some of the issues that are likely to arise in the application of the Commission’s approach.

Europe Economics has well-developed expertise in competition policy and economic regulation in the water sector, and would be pleased to help with any further issues that may arise in relation to water mergers or on other issues.

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⁸ Ofgem (2002), “Mergers in the electricity distribution sector; Policy statement”, May

⁹ Ofgem (2004), “National Grid Transco – Potential sale of gas distribution network businesses; Final Impact Assessment”, Nov