Reckon LLP
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Water mergers

[1] The Competition Commission (CC) has published for consultation a draft of its guidelines on inquiries into mergers of water companies.* The deadline for responses is Friday 29 October 2004.

The CC guidelines will need to build up confidence in the water merger control regime

[2] UK policy towards the structure of infrastructure monopolies remains haphazard. The amalgamation of all water companies in Scotland, the break-up of the gas network, substantial concentration of electricity distribution and countless changes of mind about how the railways should be run have all taken place in recent years with the Government's blessing.

[3] Against this background, the water industry in England and Wales has been distinguished by the relative stability of its regulatory regime, and a clear system of merger inquiries to assess structural change — albeit not one that has been free of controversy.

[4] The Enterprise Act reforms build on these foundations, and the substantive tests for water mergers share a focus on the role of comparators for economic regulation.

[5] However, the new test may be significantly narrower in its scope than the old "public interest" test, and this article argues that focusing purely on the loss of comparative information for regulation could lead to decisions that are not in the best interest of consumers.

[6] Given the potential narrowing of the substantive test, we also find it surprising that the CC's draft is silent on whether the CC considers that previous water merger inquiries, and/or cases from similar industries such as electricity distribution, provide relevant precedents for the application of the new rules.

[7] The requirement for the CC to produce guidelines provides an opportunity to clarify the rules, and to explain to the financial markets (which have to meet the water industry's considerable appetite for capital) how much leeway they can expect on structural change, and how much confidence they can place in the continued availability of comparative information.

[8] In particular, we argue that the final guidelines should:

(a) address the interactions between comparative information effects and competition effects, particularly competition in corporate control;

(b) clarify the extent to which the ability of parties other than Ofwat to use comparative information may be taken into account insofar as it is to the ultimate benefit of consumers; and

(c) provide an explicit framework for the assessment of remedies, and a full and frank discussion of the role, if any, of price cut remedies in the new regime.

The substantive test has been narrowed

[9] The need for guidelines to be produced arises from the Enterprise Act 2002, which, in the context of merger control:

(a) amends the substantive tests to be used in the assessment of mergers;

(b) transfers decision-making powers on mergers from the Secretary of State to the CC; and

(c) places a new duty on the CC to produce guidance.

[10] As for other types of mergers, the change in the substantive test for water mergers represents a move away from the concept of an adverse effect on public interest and towards a narrower specification of the potential adverse effects of the merger that should be assessed.

[11] For "normal" mergers (outside water, media and "public interest" cases) the new substantive test is that of a "substantial lessening of competition" (SLC). For water mergers, the test under the Enterprise Act is:

> *whether [the] merger [has prejudiced, or] may be expected to prejudice, the ability of the Director [General of Water Services], in carrying out his functions by virtue of [the Water Industry Act 1991], to make comparisons between different water enterprises.*†

[12] Prior to the coming into force of the Enterprise Act 2002, a public interest test was used for water mergers (as in all inquiries under the Fair Trading Act 1973), with the following specific qualification for water mergers:

> *In determining [...] whether any matter operates, or may be expected to operate, against the public interest the Competition Commission shall have regard to the desirability of giving effect to the principle that the Director's ability, in carrying out his functions by virtue of [the Water Industry Act 1991], to make comparisons between different water enterprises should not be prejudiced.*‡

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* Competition Commission (2004) *Water merger references made under section 32 of the Water Industry Act 1991: Competition Commission guidelines: consultation document.*

† Enterprise Act 2002, Schedule 6, Section 70. The Director refers to the Director General of Water Services (i.e. Ofwat).

‡ Water Industry Act 1991, Section 34, as amended by Section 39 of the Competition and Service (Utilities) Act 1992.

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[13] Thus, the substantive test for water mergers has been narrowed by the Enterprise Act. The ability of Ofwat to make comparisons between water companies is now to be the sole focus of the first part of the investigation, instead of something whose "desirability" the CC was merely required to "have regard to" under the old legislation.

[14] The remedies question has also been narrowed in line with the change in the substantive test. Instead of being asked to consider what action should be taken "to remedy the effects adverse to the public interest", the CC may now only take or recommend action which is:

> *for the purpose of remedying, mitigating or preventing the prejudice to the Director or any adverse effect which has resulted from, or may be expected to result from, the prejudice to the Director.*[*]

[15] Perhaps unsurprisingly given the new test, the CC guidelines are focused on the valuation of comparators from a regulatory perspective, i.e. on the impact that the loss of information has on Ofwat's work.

[16] Ofwat uses comparisons between companies for a range of purposes, including to estimate the scope for each company to improve its efficiency by "catching-up" with more efficient peers, and to establish benchmark unit prices for investment requirements.

[17] This article argues that an exclusive focus on Ofwat's use of comparative data would risk losing sight of other ways in which water mergers may operate in or against the interests of consumers.

[18] The CC guidelines do not discuss whether future inquiries into water mergers will be able to take these other effects into account, or whether the CC is prepared to disregard potential detriments to consumers simply because they do not fall within a narrow notion of a prejudice to Ofwat's ability to make comparisons.

[19] An obvious point is that the new rules appear to prevent the CC from taking market competition effects into account in a water merger inquiry. Effects on ordinary market competition might arise, for example, for supply to very large customers or for ancillary supply or purchasing activities. This problem may be addressed pragmatically by "splitting" the inquiry between an analysis of competition effects against a SLC standard, and an analysis of effects on water regulation and comparators.

[20] More subtly, and of greater concern, is the potential for legitimate consumer interest issues arising from water mergers to be "missed" through the application of the new test in accordance with the CC draft guidelines.

Competition is an important force, even for water and sewerage monopolies

[21] A key issue that risks being overlooked is competition in corporate control.

[22] The concept of competition in corporate control refers to the rivalry between investors and senior management teams to own and operate a business, such as a water company. Thus, competition takes place in a market for the control of the water company, which is at a different level in the economic "supply chain" from the supply of water and sewerage services to customers. Markets for corporate control involve transactions whereby an "owner" (e.g. a combination of shareholders, lenders and a senior management team) provides finance and direction to a business in exchange for its future profit stream.

[23] As they are separate markets at different levels in the supply chain, effective competition in corporate control can coexist with monopoly or weak competition in water services.

[24] In view of the lack of competition in markets for water and sewerage services, it is likely that rivalry in corporate control is the main way in which management teams in the water industry are exposed to competitive pressure. Whereas in other industries the pressure to perform in the product markets is often strong enough to motivate performance, for utility monopolies it is competitive processes within markets for corporate control which can be expected to keep management teams on their toes.[†]

[25] Competition in corporate control may not be as tangible as competition in an average widget market, but it is nevertheless a genuine form of market competition, which brings the same kind of benefits as any other form of competition. It can, and should, be analysed in much the same way as any other form of competition that might be affected by a merger.

[26] In particular, it is likely to be useful to define the relevant markets. For example, do the investors and managers of an electricity distribution business place an effective competitive constraint on the existing management team of a water business?

Mergers can be an expression of competition rather than an impediment to it

[27] In some cases, threats to competition in corporate control may be a reason to block a water merger.

[28] At the same time, a restrictive merger control regime — on whatever grounds — could itself eliminate or lessen competition in corporate control, by preventing water companies' management teams from exerting effective competitive pressures on each other.

[29] Thus, the analysis in individual merger cases must take careful account of the adverse effect on competition that might result from the precedent of blocking a merger.

[30] At the very least, this means that any adverse finding in a water merger case should be carefully documented and

[*] Enterprise Act 2002, Schedule 6, Section 70.

[†] Whilst competition in corporate control is often thought of as an expression of shareholder power, similarly effective market pressures are likely to exist for debt-financed companies such as Glas Cymru.

justified, so that the circumstances under which future mergers would be allowed are clear and well understood by the financial markets. This would preserve at least a degree of competitive pressure in markets for corporate control.

Comparators do not only matter to Ofwat

[31] We have argued above that, if it is to take full account of the effects of water mergers on consumers, the analysis in a water merger inquiry should not be restricted to the question of the value of a comparator.

[32] However, the value of a comparator remains a relevant consideration, and it is therefore important that all aspects of it should be taken into account.

[33] The value of comparators is not limited to the contribution that they make to the specific efficiency or performance comparisons that Ofwat might conduct. Above and beyond this regulatory use of comparators, water industry investors and managers can be expected to use comparative information in a number of other ways, which bring benefits to consumers.

[34] Information can facilitate competition in the markets for corporate control discussed above. The ability to make meaningful comparisons may strengthen competition in corporate control by reducing barriers to hostile take-over bids, as comparative information enables outsiders to identify where there may be scope for performance improvements. Thus, comparators may enhance competition in corporate control, to the benefit of consumers.

[35] The benefits of comparative information are not limited to regulation and competition in corporate control. Comparative data can also provide benchmarks for executive remuneration schemes used to provide incentives to managers to improve and maintain the efficiency of the business. If there is enough good-quality data about a range of comparable companies, then such schemes will be able to provide managers with strong incentives linked to their own company's performance, whilst limiting their financial exposure to industry-wide cost and performance shocks and therefore reducing the "risk premium" which they have to be paid (in what is a competitive employment market for management talent).

[36] Thus, the availability of comparative information may benefit customers in three ways:

(a) by enabling better regulation;

(b) by promoting competition in corporate control; and

(c) by enabling stronger managerial efficiency incentives.

Quantification of the value of comparators will remain difficult or even fallacious

[37] Previous water merger inquiries have considered a number of methods to quantify the "value of a comparator", i.e. a financial equivalent of the public interest detriment associated with the loss of comparative information.

[38] These methods have included:

(a) Estimations of the extent to which the loss of a specific comparator would "shift" the efficiency frontier derived from comparative efficiency analysis. This technique effectively assesses the short-run effect on prices of the loss of a comparator, but does not provide reliable information on longer-term effects (would future efficiency improvements be affected by the loss of a comparator?). It also assumes that comparative information enables expenditure projections to be reduced by the regulator with no follow-on effect on the cost of capital that needs to be allowed to companies, or on their behaviour — not a very realistic assumption.

(b) Estimations of the extent to which, in statistical terms, the loss of a comparator can be expected to add to the uncertainty that exists in comparative efficiency assessments. Greater uncertainty leads to either greater risks being borne by investors (and therefore higher financing costs, which are ultimately borne by consumers), or to weaker efficiency incentives as a lack of reliable comparative information forces the regulator to allow a greater element of cost pass-through in price limits (and therefore to lower efficiency and higher costs, which are ultimately borne by consumers). However, quantification of these effects is difficult and has to rely on fairly arbitrary assumptions.

[39] These methods are therefore rather unsatisfactory. This is unsurprising: quantifying the effects of a merger is always difficult, and most merger inquiries recognise the limitations of such techniques by focusing on qualitative effects (e.g. whether different forms of competition might be impeded) and using quantitative techniques only as a way of testing the validity of specific hypotheses (e.g. choosing between credible market definition options).

[40] It could be argued that this problem is not specific to water mergers. After all, competition in corporate control and the ability of investors and corporate governance structures to exploit comparative information are important in all sectors.

[41] The crucial difference is that in (potentially) competitive markets, "normal" product market competition is the ultimate source of incentives for efficiency and performance, and merger analysis can therefore focus on the extent to which a particular transaction might impede this competitive process — hence the reliance on the substantial lessening of competition test applied to product markets. This reasoning does not apply in the case of regulated monopoly businesses.

[42] Furthermore, and perhaps most importantly, the methods outlined above focus on regulatory effects of the loss of a comparator only. Thus, even if they were considered robust, they might only answer a part (and potentially a minor part) of the question of whether the merger may have adverse effects for consumers.

Clarification of the role of efficiencies and of potential "price cut" remedies is required

[43] As in any other merger case, if a relevant detriment is identified in a water merger inquiry, the CC is required to assess potential remedies, taking account of any merger-specific benefits that might exist.

[44] In cases where a detriment to competition in corporate control is found, a natural remedy (short of prohibition) may be to protect the operational separation of the merging businesses, in order to preserve an effective de-merger/partial take-over option as a potential future form of competition in corporate control.

[45] The remedies question is harder if the main detriment is a prejudice to the ability to make comparisons. Detailed data reporting requirements are unlikely to provide a fully effective remedy given that effort and resources can be re-allocated across the merged entity (indeed the ability to do so is likely to be the main benefit of the merger).

[46] Besides the remedies outlined above, several of the water merger inquiries that have taken place since privatisation have resulted in the imposition of a price cut remedy, i.e. a reduction in price limits designed to pass the expected efficiency benefits of the mergers to consumers. Similarly, Ofgem's current policy is to make adjustments to price limits in response to mergers between regional electricity distribution companies.*

[47] The economic principles that have underpinned previous water merger decisions have not always been clearly stated. In particular, it is not clear whether:

(a) passing-through the benefit of merger efficiencies to consumers of the merging companies is deemed to remedy the detriment (to all companies' consumers) of the loss of a comparator; and/or

(b) the merger is expected to create a "better" comparator (more comparable or more efficient?) which is deemed to outweigh the detriment associated with the reduction in the number of comparators; and/or

(c) the requirement for a price cut is in fact imposed by the authorities as a "filter" to reveal whether the merging companies expect such significant efficiency benefits that they are prepared to absorb the price cut.

[48] The CC's consultation draft does not provide a detailed discussion of the substantive assessment of remedies, and instead largely limits itself to an explanation of the applicable rules and procedures. This leaves unanswered the crucial question of whether price cap adjustments to pass on a merger's efficiency benefits to consumers can be used as remedies under the new regime.

Reckon is a consultancy firm providing rigorous and challenging analysis of regulation and competition issues in infrastructure industries.

Visit **http://www.reckon.co.uk/open/water_mergers** to discuss the issues raised by this article.

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* Expenditure allowances are reduced by £25 million a year after a five-year lag, in addition to the £32 million "merger tax" introduced by Ofgem in 2002.