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Dear Ms Maunsell

Competition Commission Draft Guidelines for Water Merger References

Veolia Water UK PLC in this letter comments on the Commission's draft guidance outlining its proposed approach to assessing water merger references. Because water references are mandatory a careful consideration of, and reliance upon these guidelines, will occur prior to companies making decisions on whether and how to proceed with a water merger.

We have appeared before the Commission in connection with a number of water mergers and would first observe that it is difficult in advance of appearing before the Commission to know how they will approach the matter in hand. The Commission's decisions seem to vary according to its composition and differently constituted Panels have expressed differing views on the same issues. This makes these guidelines especially important.

Of special concern is the status of Ofwat before the Commission. In our view the Commission is there to see that the rule of law applies and to ensure that both the Regulator and the water industry are on a level legal playing field with equal juridical status. The Commission should assert that it will not attach greater weight to the evidence of Ofwat than it does to that of any other party. All evidence, including that of Ofwat, should be assessed strictly on its merits.

Historically, the Commission and its predecessor has not always been persuaded by the arguments of Ofwat. However these guidelines (and particularly the section on price controls) suggests a willingness to give greater weight to the views of OFWAT than has previously been the case and to treat as a matter of law what is really a contested assertion of fact by OFWAT (see last sentence 2.2).

The regime of comparative competition is by the application of high economic theory an attempt to replicate real competition in an industry where owners exploit exclusive territorial rights. It is of particular importance that the Commission consider where ever possible ways

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to align such theory nearer to a model of how things actually work. In this context there has been too little appreciation by OFWAT, though not by the Commission, that the fundamental driver of costs in the water industry is local geography. In our view OFWAT has paid, and is still paying, insufficient attention to obtaining data based on geographical similarities in order to measure relative efficiencies.

We note that in the Vivendi reference the Commission specifically indicated that OFWAT should consider collecting sub sets of data based on geography. We are unaware of OFWAT acting upon this prompt.

We would suggest that the Commission consider including in its guidelines its views on how it will approach remedies agreed with the Regulator in advance of a reference but subject to the approval of the Commission.

To turn to the text:

The first question to be decided in relation to water mergers

One important difference between the water regime (Para 3(1) Schedule 4ZA to W1A inserted by Section 70 Enterprise Act 2002) and the general regime contained in Section 33 Enterprise Act 2002 is that the water regime refers only to “arrangements are in progress”. It does not include the words “or in contemplation” which can be found in Section 33 Enterprise Act 2002. This implies that certain mergers which are caught by section 33 are not caught by the water regime. It would be helpful if the guidelines were to explain the Commission’s view as to the difference between the two thresholds. This is of particular importance, given the mandatory reference regime.

Part 2: Prejudice to the DGWS’ ability to make comparisons

A core concept is prejudice to the DGWS’ ability to make comparisons. The test has in the past referred to the statistical accuracy with which the DGWS is able to draw conclusions from those comparisons. If so does the loss of an independent comparator inevitably gives rise to prejudice of some sort? The answer would appear to require the taking of evidence on a case by case basis. But Paragraph 2.2 of the draft guidelines seem to express a concluded view in advance. The Commission should explain the basis on which it has reached that conclusion - which itself suggests that greater attention to the procedure relating to remedies will be needed in water merger cases. We would observe that in the Vivendi Water UK PLC and First Aqua (JVCO) Limited reference the Commission focused on the more objective question of minimum number of independent water companies necessary to ensure effective operation of the regulatory regime.



EC Merger Regulation and Application of EC decision of 29 March 1995

The decision of the European Commission under Article 21 of Council Regulation (EEC) No 4064/89 (as amended) relating to the proposed acquisition by Lyonnaise des Eaux SA of Northumbrian Water Group PLC in 1995 (the EC Decision of 29 March 1995) refers to the past text of Sections 32 to 34 Water Industry 1991. Regulation 4064/89 has now been repealed and sections 32 to 34 are to be replaced with the new provisions in the Enterprise Act. It is not obvious that the said decision of the Commission still applies to those sections as modified. Has this been the subject matter of discussions between the UK and the Commission? Do these guidelines reflect the position of the Commission? Should the Commission include in its guidance its views on the jurisdictional rules that now apply?

The guidelines contain considerable discussion of the application of the EC Commission's decision of 29 March 1995. This was itself the subject of considerable debate during the Vivendi Water/First Aqua reference. The points made in the guidelines do, of course, depend on the presumption that the 1995 decision still applies.

We suggest that Commission should set out the extent to which its freedoms under English law in dealing with water merger references are affected by European law, for example in relation to the principles of proportionality and non-discrimination and the free of movement of capital.

User comparators by DGWS

In the Vivendi Water/First Aqua reference the Group took the position that the correct legal test requires it to consider the ability of the DGWS, using best practice and the most advanced statistical methods, to make comparisons (see para 2.94). Thus, the concept of the DGWS' ability to make comparisons is not limited to or constrained by his current practice. In contrast, the draft guidelines appear to endorse, without critical analysis, the current practices of the DGWS in making comparisons. This privileges the influence of Ofwat over the merger control process and grants the Regulator a greater status than statute provides. The guidelines should state that the Group will always examine afresh the application of Ofwat's current practices.

The DGWS has often made submissions placing a high financial value on the loss of a comparator. Their approach has never been endorsed by any Group. We suggest that the guidelines should comment on this issue.

Common management

At paragraph 2.19 of the draft guidelines the Commission says that, in general, comparisons are more likely to be problematic where there is common management than where there is contracting out to another company. Does this mean that a policy of contracting out operations is likely to be considered by the Commission as a good remedy? To what extent will the Commission look for such contracts to be on a long term basis? And, what would the



views of the Commission be if two or more water companies were to contract out their operations to the same contractor?

We believe that the Commission should develop its thoughts further in relation to the different impacts of common ownership and common management on the DGWS' ability to make comparisons.

Further consideration could be given in the guidelines to the views of the Commission on governance implicit in the conditions of the Instrument of Appointment. The existence of sub-sets of data relating to local geographical conditions would impact upon this issue.

Remedies – relevant customer benefits

In several water merger references the parties have argued that a merger will lead to better management and allocation of scarce water resources. The commentary on this issue is too brief. There should be a focussed discussion of the class of possible customer benefits admissible under paragraph 7(i) of Schedule 4ZA of the Water Industry Act.

Conclusion

If it would be helpful we would be pleased to provide further input to the Commission, or to attend a meeting. We note that in preparing this submission we have liaised with the law firm Simmons & Simmons who have acted for us in previous references.

Yours faithfully

A handwritten signature in black ink, appearing to read "Michael Butcher", followed by a horizontal line.

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