

**Water Merger References made under Section 32 of the Water Industry
Act 1991
Competition Commission Guidelines**

Consultation document

Water Merger References:

Competition Commission Guidelines

Consultation Draft

Introduction

This consultation document seeks views on guidance that the Competition Commission (CC) proposes to issue outlining its proposed approach to assessing water merger references referred to it by the Office of Fair Trading (OFT) under the water merger regime set out in the Water Industry Act 1991 as amended by the Enterprise Act 2002 and the Water Act 2003. The guidance will form part of the advice and information published by the CC under the Enterprise Act 2002.

The guidance has been drawn up following consultation with members of the CC.

Responses

You can respond to this consultation:

by email to: susan.maunsell@competition-commission.gsi.gov.uk

by post to:

Susan Maunsell
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Enquiries to

email as above or telephone 020 7271 0287 /fax 0207271 0367

Closing date

Responses should be received by 29 October 2004.

Executive summary

The Water Industry Act 1991 put in place a special merger regime for mergers between water enterprises (that is, water and sewerage undertakings). The Enterprise Act 2002 made changes to how all mergers are regulated, and included provisions (not yet in force) to make amendments to the Water Industry Act merger provisions. These changes will align the water merger provisions more closely with the Enterprise Act general merger provisions. The CC is determinative in merger cases, including water mergers, referred to it by the OFT. The changes include the questions which the CC has to answer in respect of water mergers.

The draft water merger guidance attached is intended to apply to water mergers referred to the CC by the OFT in the same way as *Merger References: Competition Commission Guidelines* (CC2) already applies to general merger references. It covers the CC's approach to the questions of whether a merger is anticipated or has taken place and if so, whether that merger has prejudiced or may prejudice the ability of the Director General of Water Services to make comparisons between water enterprises. It describes how that latter question might be addressed. It goes on to describe how, if the CC finds prejudice, it might go on to consider what remedy might be appropriate and to what extent there may be customer benefits from the merger which should be taken into account in deciding on the remedy.

It is intended that the amendments to the Water Industry Act 1991 will be brought into force around the end of 2004 and at that point the new water mergers regime will take effect.

The proposed guidance is self explanatory and there are no particular sections of the document that the CC wishes to draw to consultees' attention. We would, however, welcome comments on the guidance either of a general nature or on any specific points.

How to respond

See above for contacts and final date.

When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

Copies of this consultation document are available from the CC's website:
www.competition-commission.org.uk

Confidentiality

The CC may wish to publish your response. If you do not want all or part of your response or name made public, please state this clearly in the response. Any confidentiality disclaimer that may be generated by your organisation's IT system or included as a general statement in your fax cover sheet will be taken to apply only to information in your response for which confidentiality has been requested.

Next steps

A summary of the consultation and outcome will be provided during November 2004 on www.competition-commission.org.uk and the final guidance will be published.

MERGER REFERENCES: COMPETITION COMMISSION GUIDELINES

Consultation Document

Contents

| | |
|--|----|
| Part 1: Introduction..... | 4 |
| Purpose of Guidance | 4 |
| Water Merger References..... | 5 |
| Water Merger | 8 |
| Water Enterprises ceasing to be distinct | 8 |
| Part 2: Prejudice to the DGWS's ability to make comparisons between different water enterprises..... | 10 |
| Introduction | 10 |
| Application of EC Decision of 29 March 1995..... | 10 |
| Use of comparators by DGWS..... | 12 |
| Effects of the merger on the value of the DGWS's comparisons | 15 |
| Part 3: Remedial Action | 19 |
| Introduction | 19 |
| The remedy questions..... | 19 |
| Consideration of appropriate remedies | 20 |
| The cost of remedies and proportionality | 21 |
| Effectiveness of remedies | 22 |
| Types of remedies..... | 23 |
| Addressing the prejudice to the DGWS's ability to make comparisons..... | 24 |
| Prohibition and divestment..... | 24 |
| Partial prohibition and divestment | 25 |
| Regulatory remedies | 26 |
| Relevant customer benefits..... | 26 |
| Possible relevant customer benefits..... | 27 |
| Relevant customer benefits and remedies | 28 |
| Undertakings and Orders | 29 |
| Procedural and other aspects of undertakings and orders..... | 30 |

Part 1: Introduction

Purpose of Guidance

- 1.1 This guidance forms part of the advice and information published by the Competition Commission (the Commission) under section 106(3) of the Enterprise Act 2002 (the Act)¹. It explains how the Commission intends to address the questions it is required to answer in respect of water merger references made to it under section 32(a) or (b) of the Water Industry Act 1991 (the WIA). In this guidance we refer to such references as water merger references.
- 1.2 Information on procedural aspects of the Commission's investigation can be found in *CC1 Competition Rules of Procedure* (the Rules)² and *CC4 General Advice and Information*. Information about these and other publications of the Commission and the Office of Fair Trading relevant to merger inquiries can be found in the Annex to this document.
- 1.3 This guidance reflects the views of the Commission at the time of publication. It is based upon current market conditions of the water³ industry and the functions of the Director General of Water Services (DGWS)⁴ at the date of publication. These may change, as may the water industry, economic theory, the legal context, best practice and the use made by the DGWS of comparisons between water enterprises. New guidance may be published from time to time to reflect such change or the Commission's experience in applying the new regime. In addition, the Commission's approach may change if the Secretary of State exercises her power to make regulations on matters to which the Commission may or must have regard in deciding

¹ Section 106 (3) applies to water merger references by virtue of regulation [48] of The Water Mergers (Modification of Enactments) Regulations 2004 (the Water Mergers Regulations) – to be published.

² Reference in this guidance to Rules is to the Rules last published on the Commission's web site www.competition-commission.org.uk

³ references to water include water and sewerage

⁴ In this guidance we continue to refer to the regulator as the DGWS. Section 34 of the Water Act 2003 contemplates the regulator being replaced by the Water Services Regulation Authority (the Authority) Once that happens, which will not be before April 2005, references in this guidance to DGWS should be read as references to the Authority.

whether to take any remedial action.⁵ This guidance may be revised in the light of any such regulations.

1.4 In addressing the questions the Commission⁶ must consider in respect of water merger references, the Commission will consider each case on its facts, applying the statutory provisions in force at the time. It will have regard to this guidance but this guidance is not binding and its application depends on whether appropriate to the case in hand.

1.5 Part 3 of the Act applies to a merger of two or more water enterprises.⁷ This guidance applies only to water merger references where the Commission applies a different test from that applied in normal mergers. Some mergers may include both water enterprises and other enterprises. For guidance on the Commission's approach to any other parts of the merger (i.e. the non-water enterprises elements of a merger involving both water and other enterprises, which would include the application of the substantial lessening of competition test) see *CC2: Mergers References: Competition Commission Guidelines*.

Water Merger References

1.6 The OFT is subject to a duty to refer mergers between two or more water enterprises to the Commission⁸ if the OFT believes that it is or may be the case –

- (a) that arrangements are in progress, which, if carried into effect, will result in a merger of any two or more water enterprises; or
- (b) that such a merger has taken place.

⁵ The power to make the regulations is under Para. 4(3) of Schedule 4ZA to the Water Industry Act 1991 (WIA), inserted in the WIA by section 70 of the Enterprise Act 2002 (the Act). At the time of publishing this guidance, no such regulations had been made.

⁶ In respect of each reference a group is appointed to carry out the Commission's functions. For further information about the appointment of groups and the procedures that apply see *CC4 Rules and General Advice and Information*.

⁷ "Water enterprise" is an enterprise carried on by a company appointed under section 6 of the WIA to be a water undertaker or a sewerage undertaker (Sections 6 and 35 (1) of the WIA, the latter inserted by section 70 of the Act and amended by paragraph 27 (2) of Schedule 7 to the Water Act 2003.

⁸ Section 32 WIA. This section does not extend to Scotland.

1.7 The duty does not apply if the value of the turnover of the water enterprise being taken over or the value of the turnover of each of the water enterprises belonging to the person making the takeover does not or would not exceed £10m⁹.

1.8 The value of the turnover of the water enterprise being taken over is calculated by aggregating the total value of the turnover of the water enterprises which cease to be distinct and deducting¹⁰ -

- (a) the turnover of any water enterprise continuing to be carried on under the same ownership and control; or
- (b) if there is no water enterprise continuing to be carried on under the same ownership and control, the turnover which, of all the turnovers concerned, is the turnover of the highest value.

The questions to be decided in relation to water merger references

1.9 The first questions the Commission has to answer in respect of an anticipated water merger are:¹¹

- “(a) whether arrangements are in progress which, if carried into effect, will result in a water merger; and*
- (b) if so, whether that merger may be expected to prejudice the ability of the Director, in carrying out his functions by virtue of this Act, to make comparisons between different water enterprises.”*

1.10 The first questions the Commission has to consider in respect of a completed water merger are¹²:

- “(a) whether a water merger has taken place; and*
- (b) if so, whether that merger has prejudiced, or may be expected to prejudice, the ability of the Director, in carrying out his functions by*

⁹ Section 33 (1) WIA as inserted by section 70 of the Act.

¹⁰ Section 33(2) WIA as amended by section 70 of the Act (The Water Mergers (Determination of Turnover) Regulations 2004 – currently being consulted on by DTI – set out details of how to calculate turnover.

¹¹ Para 3 (1) Schedule 4ZA to WIA inserted by section 70 of the Act. See paragraph 1.15 below for definition of a water merger.

¹² Para 3(2) Schedule 4ZA to WIA

virtue of this Act, to make comparisons between different water enterprises.”

1.11 In relation to anticipated mergers, there is an adverse outcome if the water merger may be expected to prejudice the ability of the DGWS to make comparisons between different water enterprises, and in relation to completed mergers, there is an adverse outcome if the water merger has prejudiced or may be expected to prejudice that ability¹³.

1.12 If the Commission decides that there is an adverse outcome it must decide the following additional questions¹⁴:

- “(a) whether action should be taken by it under section 41(2) [of the Enterprise Act] 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;*
- (b) whether it should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the prejudice to the DGWS’s ability to make comparisons or any adverse effect which has resulted from, or may be expected to result from, the prejudice; and*
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.”*

1.13 If in the case of a completed merger reference the Commission is satisfied that the reference was not made within the prescribed four month period,¹⁵ the Commission must state that fact in its report and may not take remedial action.¹⁶

1.14 Part 1 goes on to describe the conditions that constitute a water merger, Part 2 describes how the Commission will consider what constitutes prejudice, and Part 3 describes how the Commission will consider remedies.

¹³ Section 35(2)(b) of the Act as modified by The Water Mergers Regulations.

¹⁴ Sections 35(3) and 36(2) of the Act as modified by The Water Mergers Regulations [13 and 14.] – to be published.

¹⁵ That is, four months from the date of the merger or, if it is later, the day on which the material facts about the merger first come to the attention of the OFT or are made public.

¹⁶ For more information see paragraph 3.2.

Water Merger

1.15 A 'water merger' is a merger of any two or more water enterprises¹⁷, a water enterprise being an enterprise carried on by a company appointed under section 6 of the WIA to be a water undertaker and/or a sewerage undertaker.¹⁸ A merger of two or more water enterprises is a reference to those enterprises ceasing to be distinct.

Water Enterprises ceasing to be distinct

1.16 Any two water enterprises cease to be distinct if they are brought under common ownership or common control (whether or not the business to which either of them formerly belonged continues to be carried on under the same or different ownership or control). Sections 26 and 27 of the Act describe the particular circumstances in which enterprises must be treated as being under common control, when a person or group of persons may be treated as bringing an enterprise under his or their control, and how the time when enterprises cease to be distinct is decided when control is transferred by stages.¹⁹ Section 29 of the Act specifies the circumstances in which a series of transactions may, if the Commission considers it appropriate, be treated for the purposes of the reference as having occurred simultaneously on the latest date they occurred.

EC Merger Regulation

1.17 Mergers between enterprises whose combined turnover exceeds the thresholds set in the EC Merger Regulation (ECMR)²⁰ will have a 'community dimension' giving the European Commission exclusive competence to apply the provisions of the ECMR. Under Article 21 of the ECMR, member states may not apply their national legislation on competition to mergers which fall within the ambit of the ECMR. As an exception to this general prohibition,

¹⁷ Para 8 Schedule 4ZA to the WIA inserted by section 70 of the Act.

¹⁸ See Footnote 7.

¹⁹ These sections apply to water merger references pursuant to paragraph 1 of Schedule 4ZA to the WIA inserted by section 70 of the Act.

²⁰ EC Merger Regulation means Council Regulation (EEC) No 4064/89 as amended or Council Regulation (EC) No139/2004 as applicable.

however, member states may take appropriate measures to protect legitimate interests other than those taken into consideration by the ECMR itself, provided that the measures are compatible with the general principles and other provisions of EC law. By a decision of 29 March 1995 (the EC Decision), the European Commission recognised the legitimate interest of the UK in applying sections 32 to 34 of the WIA, subject to the provisions set out in the EC Decision itself.

- 1.18 The EC Decision was taken in the context of the proposed acquisition by Lyonnaise des Eaux SA of Northumbrian Water Group PLC. At that time sections 32 to 34 of the WIA applied a qualified public interest test to water mergers. However, the EC Decision was not limited to that transaction alone and recognised that the UK has a legitimate interest in maintaining sufficient comparators in the water industry to enable effective regulation. While the European Commission continues to recognise the maintenance of sufficient comparators as a legitimate interest for the purposes of Article 21 the Commission will continue to receive references relating to mergers that have a community dimension. Consequently, where appropriate this guidance refers to the provisions of the EC Decision to illustrate the approach taken by the EC to date.
- 1.19 In these cases the OFT will refer the merger to the Commission under the normal route of either subsection (a) or (b) of section 32 of the WIA.
- 1.20 The period in which the Commission must prepare and publish its report is the same as for references made by the OFT under sections 22 or 33 of the Act. For more information about the time-limits and procedures see *CC4 General Advice and Information* paragraph 6.7.

Part 2: Prejudice to the DGWS's ability to make comparisons between different water enterprises

Introduction

2.1 The second question the Commission has to decide is whether the water merger has prejudiced, or may be expected to prejudice, the DGWS's ability, in carrying out his functions, to make comparisons between different water enterprises.

2.2 A water merger brings under common ownership two or more water enterprises. The merging water enterprises must continue to operate under separate licences unless their licences are amended, which would require the DGWS's approval. In the absence of licence changes, the DGWS will continue to receive separate information from each of the merging water enterprises and can continue to use this to make comparisons. In general, however, the Commission considers that companies under common ownership may be expected to behave in similar ways and hence that a water merger will affect the value of comparisons made by the DGWS.

2.3 In each case, the Commission will assess whether the impact of the merger on the DGWS's ability to make comparisons is adverse and significant enough to amount to prejudice. Paragraphs 2.8 – 2.14 explain briefly the main areas where the DGWS makes comparisons and paragraph 2.16 sets out the factors that the Commission may take into account in its assessment. First however the effect of the EC decision of 29 March 1995 has to be considered (see paragraphs 1.17 -1.18 above).

Application of EC Decision of 29 March 1995

2.4 Paragraph 5 of the EC Decision states:

“In order not to go beyond the interest pursued by the UK regulatory legislation other issues in relation to mergers between water companies can only be taken into account to the extent that they affect the control

regime as set out above. These other issues would principally include the allocation of cost savings arising from the merger or the effect of the merger on the level of water charges and which would be used in the calculation of the pricing formula for the merged company. By contrast, the UK authorities are not entitled to consider other matters which the Commission must take into account in assessing concentrations that have a Community dimension and which do not directly relate to the operation of the regulatory regime.”

2.5 As explained in Part 1, at the time of the EC Decision, the test to be applied by the Commission was a qualified public interest test. When applying the new ‘prejudice to the DGWS’s ability to make comparisons’ test, the Commission’s approach to water merger references as described in this Part will accord with the requirements of the EC Decision.

2.6 Paragraph 6 of the EC Decision provides that:

“... the implementation of this legislation must not be carried out in a discriminatory manner. The minimum number of independent water companies should therefore not be higher than necessary to ensure the effective operation of the regulatory regime in order to be appropriate and proportional to the objective in question.”

2.7 Consequently, where the Commission has jurisdiction over water mergers with a community dimension, the Commission will be guided by the need to maintain the minimum number of independent water enterprises necessary to ensure the effective operation of the regulatory regime, and thus to ensure that the UK authorities apply sections 32 to 34 of the Water Industry Act (WIA) in a manner which is non-discriminatory, appropriate and proportionate to the objectives of the legislation, subject to the general principles and other provisions of EC law. Therefore, the Commission may reach a finding that there is an adverse outcome only if the merger materially impairs the effectiveness of the regulatory regime compared with the situation that would exist in the absence of the merger.

Use of comparators by DGWS

2.8 The DGWS is responsible for the economic regulation of the water industry in England and Wales. Section 2 of the WIA²¹ imposes duties and confers powers on the Secretary of State for Environment, Food and Rural Affairs (the Secretary of State for the Environment) and the DGWS. They are required, among other matters: to exercise their powers and perform their duties in the manner they consider best calculated to further the interests of customers; to secure that the functions of water enterprises are properly carried out in every area of England and Wales, and that such enterprises are able to finance the proper carrying out of their functions; and to promote economy and efficiency and facilitate effective competition on the part of water enterprises.

2.9 The main instrument of economic regulation is the provision in each company's licence (referred to in the WIA as the instrument of appointment) for a cap on annual price movements. Under the current licence provisions the DGWS sets this for each water enterprise for a five-year period following a price review (known as the periodic review). The first periodic review covered the years 1995/96²² to 1999/00, the second periodic review covered 2000/01 to 2004/05 and the current periodic review covers 2005/06 to 2009/10. A company wishing to dispute the DGWS's determination of its price cap may appeal to the Commission for a redetermination.

2.10 The DGWS bases his determinations of the companies' price caps on projections of the companies' costs for the period concerned. Under the general approach used by the DGWS (and also the Commission) in previous periodic reviews and proposed for the current one (covering 2005/06 to 2009/10), price caps are set so that each regulated business is projected to earn revenue equal to the total of projected operating costs, projected depreciation and projected infrastructure renewals charge²³ plus the cost of

²¹ The precise duties will be amended when section 39 of the Water Act 2003 is commenced, and the WRSA is set up, not before 1 April 2005.

²² 1995/96 means the 12 month period starting 1 April 1995.

²³ Infrastructure renewals charge is charged on underground assets, which are subject to renewals accounting, and depreciation is charged on other assets.

capital on projected regulated capital value. The DGWS's efficiency assessments enter in the following ways.

- (a) The DGWS's operating cost projections for each company take into account both its historical level of costs and an assessment of its efficient level of operating costs²⁴ based on econometric modelling of all water companies' performance;
- (b) The DGWS's projections of depreciation, infrastructure renewals charge and regulated capital value are affected by the DGWS's projections of each company's required capital expenditure on maintaining and enhancing its assets.
 - (i) The DGWS's projections of capital expenditure on maintenance take into account the historical level of expenditure by the company, the DGWS's assessment of whether this is sufficient to maintain serviceability of its network and the DGWS's assessment of the efficiency of the company's capital maintenance expenditure, which is informed both by econometric modelling and a comparison of companies' costs for various standard asset works (known as the 'cost base').
 - (ii) The DGWS's projections of capital expenditure on enhancement are based on his assessment of the projects that are needed and the cost of implementing them; the DGWS adjusts the companies' figures for efficiency, using the cost base, and may also challenge them for scope and consistency, for instance where one company's general approach can be demonstrated to be inferior to that of another company.

This is a condensed summary of price cap methodology. The DGWS's present approach is set out in detail in his methodology papers for the current periodic review.

2.11 Comparisons between companies play an important role in the DGWS's determination of price caps for two reasons. First, the DGWS uses

²⁴ In addition allowance is made for any operating costs associated with new requirements which are not reflected in the historical data.

comparisons of companies' approaches and their estimated capital costs to help estimate the efficient future level of capital expenditure. Second, the DGWS uses econometric modelling of companies' historical operating costs, together with estimates of future efficiency improvements, to estimate the efficient level of future operating expenditure. (The DGWS also makes some use of econometric modelling of capital maintenance expenditure). Econometric modelling is used to adjust for differences between companies (eg in geography and heritage) which affect operating costs. The number of comparators is of particular importance to econometric modelling since its statistical robustness depends on the number of observations.

2.12 At periodic reviews, comparisons between companies are an important aid to the DGWS in projecting costs rather than a source of direct competition between companies. The DGWS's approach to water regulation is not an example of pure yardstick or comparative competition since a water company's price cap is affected by its own costs as well as other water companies' costs²⁵. For example, at the 2000/01 to 2004/05 periodic review, the DGWS set price caps broadly on the basis that each company would reduce operating costs over five years by about 60 per cent of the excess of its own costs over the adjusted costs of the company at the frontier of efficiency. (Thus in the first year price caps were assumed to reduce by about 12 per cent of the excess). Furthermore, the DGWS's approach sets price caps for the most efficient company on the basis of its own costs together with an estimate of the reduction in costs due to forecast improvements in the efficiency frontier.²⁶ This is in contrast to pure yardstick regulation where the most efficient company's price cap reflects other comparable companies' costs and hence it earns profits over and above the cost of capital, equal to the difference between its own costs and the costs of the comparator companies. Under the DGWS's approach, companies' incentive to reduce costs results principally from the price cap being fixed for five years (so that

²⁵ Under pure yardstick regulation, a company's price cap reflects only the costs of other comparable companies (A. Shleifer, *A theory of yardstick competition*, Rand Journal of Economics, Autumn 1985.)

²⁶ The DGWS's current methodology does provide additional rewards for the most efficient companies if they out-perform against expected costs. See *A further consultation on incentive mechanisms: Rewarding future out-performance and handling under-performance of regulatory expectations*, OFWAT consultation paper 24 June 2003 and *Our conclusions on rewarding out-performance and handling under-performance*, MD191, 25 March 2004.

companies retain any cost savings compared to the DGWS's projections for five years²⁷).

2.13 The DGWS makes annual comparisons of the quality of companies' customer service and relative performance is reflected in an adjustment to price caps. Companies' price caps for 2000/01 to 2004/05 included adjustments of +0.5% (for companies with the highest quality of service) to -0.5% (for companies with the lowest quality of service).

2.14 The Commission considers that the advantages to the DGWS of comparisons go beyond the effects on setting price caps at periodic reviews. The DGWS publishes tables comparing companies' performance on various matters including quality of customer service and relative efficiency and companies are concerned about their position in these tables and stimulated to seek improvements. (Any such effect is separate from any longer term effect on efficiency through price caps). Second, comparative information is useful to the DGWS in appraising company proposals in a variety of areas, including tariffs, leakage and transfer pricing, and may enable the DGWS to negotiate improved proposals that better fulfil his functions.

Effects of the merger on the value of the DGWS's comparisons

2.15 The Commission considers that an increase in common ownership across one or more companies may be expected to affect the value of the DGWS's comparisons for the following reasons:

- (a) a reduction in the extent of independent ownership may reduce the reliance the DGWS can place on efficiency comparisons in setting price caps and, given the need to ensure water companies can finance their functions, lead him to set higher price caps (for all companies) than would otherwise be the case;
- (b) to the extent that that the DGWS can place lesser reliance on efficiency comparisons, water companies may expect future price caps to be based

²⁷ Cost savings made towards the end of the five year period are maintained for five years through an incentive allowance.

to a greater extent on factors related to their own costs and to a lesser extent on factors independent of their own costs and consequently may have less incentive to achieve costs savings;

- (c) a reduction in the extent of independent ownership may also be expected to affect the wider use by the DGWS of comparisons for benchmarking purposes.

The Commission may need to consider whether it would be practicable and cost-effective for the DGWS to use alternative methods of comparison to 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.

2.16 In assessing the impact of the merger on the value of the DGWS's comparisons, the Commission will take into account the following factors, which are discussed in paragraphs 2.17 to 2.22 below:

- (a) the extent of common ownership (2.17);
- (b) any other factors suggesting that the companies involved in the merger could remain to some extent under independent management after the merger (2.18);
- (c) the extent to which the costs of one or all of the merging companies are, before the merger, not independent of the costs of other water companies (2.19) ;
- (d) any particular similarities between the companies involved in the merger (2.20);
- (e) whether the company or companies being taken over are among the most efficient, for example, the loss of a frontier or price-setting company might mean that the DGWS would have to set softer price targets for the whole industry (2.21);
- (f) the number and quality of remaining independent comparators (2.22).

The Commission will also take into account any other relevant factors.

- 2.17 A transaction may qualify as a water merger but significant interests may continue to be held after the merger by other parties in one or more of the companies involved in the merger. This could make it more likely that the companies continue under independent management after the merger (for instance as a result of the existence of a shareholder agreement) and hence less likely that the merger prejudices the ability of the DGWS to make comparisons.
- 2.18 Similarly, the Commission will also consider any other factors suggesting that the companies would continue to some extent under independent management after the merger and whether this reduces the impact on the DGWS's comparisons.
- 2.19 But where aspects of the operation of one or more of the companies involved in the merger are, before the merger, not independent of other water companies, the effect on the DGWS's comparisons is likely to be less than otherwise. This may be the case where a company's choice of similar operating techniques, methods, technologies or management tools to other water companies might have partly diminished the value of one or all of the merging companies as a comparator. A possible example is if the operations are contracted out to another water company. Nevertheless, the Commission considers that, in general, comparisons are likely to be more problematic where there is common management than where there is contracting out to another company.
- 2.20 Where merging companies have specific similarities which are not shared by other water companies, comparisons are likely to be of special importance to the DGWS and are likely to have a greater impact on the DGWS's comparisons. For example, comparisons of similar sized companies are likely to be particularly valuable as may be those with similar geological and other conditions.
- 2.21 The DGWS's price caps are partially based on costs of the most efficient companies. Hence, a merger affecting one or more of the most efficient

companies is likely to be of greater significance to the DGWS's comparisons, at least in the short term. Of course, past performance is not necessarily a guide to future performance; hence it is not only mergers of the most efficient companies that are of concern. Where companies come under common management, they might be expected to adopt the methods of the more efficient individual management but this may not always be the case. (Price reductions resulting from merger efficiencies are considered further in paragraphs 3.33 -3.34).

2.22 As noted above (paragraph 2.15(a)), the robustness of econometric modelling declines as the number of independent observations declines. Generally, the smaller the number of remaining independent comparators, the greater is likely to be the impact of a merger on the quality of the DGWS's comparisons. For this reason a merger of companies supplying sewerage services (where during 2000 there were only 10 comparators, including Glas Cymru which contracts out the management of its sewerage operations to another company) is likely to have a greater impact than a merger that reduces the number of companies only supplying water services (where during 2000 there were 20 independent comparators including Glas Cymru²⁸).

2.23 In considering the impact of a merger on the DGWS's comparisons, the Commission will take into account all the factors set out above and not just the effect on the robustness of econometric modelling. Hence the impact depends on the circumstances of the merger under consideration and it is not possible to state a minimum number of comparators below which the DGWS's ability to make comparisons would be prejudiced.

²⁸ Excludes one very small company and treats as a single independent comparator three companies which are majority owned by Vivendi Water UK.

Part 3: Remedial Action

Introduction

3.1 This part considers remedies, starting with the statutory questions the Commission has to answer for each water merger reference if it has decided that the merger situation has or is likely to have an adverse outcome (see paragraphs 1.9 – 1.10 above). It then describes the matters the Commission will take into account when determining the appropriateness of remedies, and finally how the Commission will take relevant customer benefits into account when deciding on appropriate remedial action.

The remedy questions

3.2 If the Commission has decided on a reference under section 32 of the WIA that there is an adverse outcome then it has to decide the three remedy questions (see paragraph 1.12). However, except when the situation described in paragraph 3.3 applies, no action may be taken in respect of a completed merger unless the reference was made within the period of four months beginning with the date of the merger or, if later, the day on which material facts about the merger first come to the attention of the OFT or were made public²⁹.

3.3 The prohibition on taking action does not apply if the reference could not have been made earlier than four months before the date on which it was made because of the EC Merger Regulation or anything done under or in accordance with its provisions³⁰ or in certain other defined circumstances.³¹

3.4 The Commission will first consider whether it should itself take remedial action to remedy the prejudice to the DGWS's ability to make comparisons or any adverse effect which has resulted from, or may be expected to result from, the prejudice to the DGWS's ability to make comparisons. This would

²⁹ Para 5 of Schedule 4ZA of WIA inserted by section 70 of the Act.

³⁰ Section 122 of the Act is modified by regulation 54 of The Water Mergers Regulations. The EC Merger Regulation means Council Regulation (EEC) No. 4064/89 as amended.

³¹ Refer idc to possible extensions under the main SI: (a) by agreement (b) following a s31 notice for information (c) referral after a possible Art 22 case.

take the form of either using its order making powers or accepting undertakings from the parties (see paragraphs 3.38 to 3.42 below). The second question is whether the Commission should recommend that remedial action should be taken by others, such as Ministers and regulators, including the DGWS. Such recommendations cannot bind the person to whom they are addressed. They can be additional or alternative to any remedial action taken by the Commission. The third question specifically asks the Commission to address what action should be taken and what it is designed to address.

- 3.5 In deciding these questions, the Commission shall “in particular have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse outcome and any adverse effects resulting from it.”³²

Consideration of appropriate remedies

- 3.6 Although the Commission must always consider the appropriateness of any remedial action, it is unlikely that the Commission would decide to take no remedial action if it has decided that a merger results or is expected to result in an adverse outcome. Examples of exceptional circumstances where the Commission might conclude that no action was appropriate might be where the costs of any practicable remedy seemed disproportionate in the light of the extent of the prejudice to the DGWS's ability to make comparisons. However, even in these circumstances, the Commission, having decided that no action should be taken by it, might recommend action by others.
- 3.7 The WIA enables the Commission, under certain circumstances, to take into account any relevant customer benefits that arise from the merger, when deciding upon remedial action. These circumstances are: first, when the consideration of those benefits would not prevent a solution to the prejudice concerned; and secondly, when the benefits which may be expected to

³² Sections 35(4) and 36(3) of the Act are applied to water merger references by paragraph 2 of The Water Mergers Regulations and as amended by paragraphs 13(c) and 14(b) of The Water Mergers Regulations respectively.

accrue are substantially more important than the prejudice concerned³³. This consideration too might lead to the decision that no action should be taken. The circumstances in which relevant customer benefits can be considered, and what constitutes a relevant customer benefit, are described later in this part.

- 3.8 The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. When deciding what an appropriate remedy is, the Commission will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality. These are discussed in the next sections.

The cost of remedies and proportionality

- 3.9 The Commission must have regard to the reasonableness of any remedy, and this will include consideration of the costs of any action it might decide is appropriate. The Commission will not require a remedy that it considers is disproportionate in relation to the prejudice to the DGWS's ability to make comparisons or any adverse effects resulting or which are expected to result from such prejudice. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that it considers imposes the least cost or that is least restrictive. In particular, when deciding whether to take action and what action to take in respect of mergers to which the EC Decision applies, the Commission will take into account its obligation to ensure that the action it decides should be taken is not disproportionate to the detriment found.³⁴

- 3.10 The Commission will generally include in its consideration of parties' costs the costs of implementing a remedy. However, for completed mergers the Commission will not normally consider the costs of divestment to the parties as it is open to the parties to make merger proposals conditional on competition authorities' approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be prohibited subsequently, and the

³³ Paragraph 4 of Schedule 4ZA to the WIA inserted by section 70 of the Act.

³⁴ See paragraph 2.7.

Commission will normally expect this risk to have been reflected already in the acquisition price. Since the cost of divestment was, in essence, avoidable, the Commission will not, in the absence of exceptional circumstances, accept that the cost of divestment should be considered in the setting of remedies.

- 3.11 Normally costs to the companies of foregone economies will only be considered in the context of relevant customer benefits. Other costs such as environmental costs or the social costs of unemployment will not be assessed by the Commission in its consideration of remedies, which are intended to address the prejudice to the DGWS's ability to make comparisons.
- 3.12 The Commission will endeavour to minimise any ongoing compliance costs to the parties, subject to the effectiveness of the remedy not being reduced, and will have regard to the costs to the OFT and/or DGWS in implementing, and monitoring compliance with, any remedies that the Commission may put in place or recommend.

Effectiveness of remedies

- 3.13 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.
- 3.14 First, a factor bearing on the effectiveness of any remedy is whether the remedy is clear to the person to whom it is directed and also to other relevant interested parties, for example, the OFT, which has responsibility for monitoring compliance, and the DGWS. Other examples of interested parties include competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the OFT's attention any concern that a remedy is not being complied with.
- 3.15 A second consideration is the prospect of the remedial action being implemented and complied with. Some remedies are a commitment as to future behaviour or to a standard of acceptable future behaviour. There may

be less certainty with some remedies compared to others that the remedies will have the desired effect. A relevant factor will be the ease of monitoring notwithstanding the possibility of establishing a compliance programme. The effectiveness of any remedy is reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One-off remedies that change the structure of the market (so-called structural remedies) are (subject to the proportionality test as described in paragraph 3.9) likely to be preferable to remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) as they address the effect of the merger directly and, once implemented, will require comparatively little, if any, monitoring or enforcement of compliance.

3.16 A third consideration is the timescale within which the effects of any remedial action will occur. Some remedies will have a more or less immediate effect, in eradicating any prejudice to the DGWS's ability to make comparisons, while the effects of others will be delayed. There may be particular uncertainty about the timescale within which results can be expected when the remedy calls for action by some other person, for example a recommendation to government to change regulations. The Commission will tend to favour a remedy that can be expected to show results in a relatively short time period – so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.

Types of remedies

3.17 The Commission will consider either of the following types of remedies:

- (a) remedies that are intended to restore all or part of the *status quo ante*, for example:
 - prohibition of a proposed merger;
 - divestment of a completed acquisition;
 - partial prohibition or divestment (i.e. covering part of one or more of the merging companies' business)
- (b) remedies that are intended to decrease the prejudice to the DGWS's ability to make comparisons and any other adverse effect resulting from the prejudice, for example:

- amendments to the company's licence, for instance regarding provision of information;

Addressing the prejudice to the DGWS's ability to make comparisons

3.18 In addressing the question of which remedies would be appropriate, and would provide as comprehensive a solution as is reasonable and practicable to address the prejudice to the DGWS's ability to make comparisons and any adverse effects resulting from the prejudice, the Commission will take account of how adequately the action would remedy, prevent or mitigate the concerns caused by the merger.

3.19 The Commission's starting point will be to choose remedial action that will prevent the prejudice to the DGWS's ability to make comparisons and any resulting adverse effects. Given that the effect of the merger is to change the structure of the industry, remedies that aim to restore all or part of the status quo ante industry structure are likely to be a direct way of addressing the adverse effects. However, issues such as the effectiveness of the remedy, the costs associated with the remedy and relevant customer benefits that would be foregone may mean that other types of remedy need to be considered. The Commission may decide to impose more than one type of remedy.

Prohibition and divestment

3.20 With a proposed merger, the most effective remedy will often be the prohibition of the merger. This is usually implemented by an undertaking from the parties not to proceed with the proposal. A complication may be that the potential acquirer has, in connection with the relevant merger situation, acquired a shareholding in the target company. This will usually need to be reduced to a specified maximum level, below which the Commission judges there could be no possibility of material influence, within a specified and reasonable time period.

3.21 For mergers already completed, the most effective remedy may be divestment of the acquired business, and in such cases the Commission will not normally take into account the private costs incurred by firms in effecting the divestment. The Commission would expect remedial action, including

divestment, to occur within a specified and reasonable time after the Commission has published its decision in order to minimise the possible reduction in the competitiveness of the business to be divested. It is not possible to be prescriptive in this guidance about the period within which a divestment must be made. When deciding the period, the Commission will take account of all the circumstances including market conditions and the adverse effects to be remedied. Until the divestment is complete, measures intended to safeguard the competitiveness of the business, including the appointment of a trustee or other person to monitor the process, may be implemented. The Commission will not consider the private costs incurred by firms in divesting when considering remedies. The Commission will generally insist on having the right to approve the prospective purchaser and the divestiture agreement before the parties may proceed with the divestiture.

- 3.22 As an alternative to either prohibition or divestment of the acquired business, the Commission may consider divestment of the acquirer's holdings in other water enterprises, where this would restore the DGWS's ability to make comparisons as effectively as prohibition of the merger.

Partial prohibition and divestment

- 3.23 Partial prohibition and divestment (rather than outright prohibition or full divestment) may be an appropriate remedy in some cases. This would be the case when the DGWS's ability to make comparisons would be restored by divestment of part of one of the merging companies. A partial divestment might be of a stand-alone, going-concern business or of physical assets, for instance those serving part of a company's licence area.

- 3.24 There are two key questions that will help to determine whether partial divestment can be an effective remedy:

- (a) whether the assets to be divested provide the basis of a viable business that can operate independently of the merging firms and can be expected to provide the DGWS with an effective comparator within a reasonable time limit;
- (b) whether a purchaser of the assets will be capable of operating the assets and running a viable, competitive business.

As with other remedies, the Commission will have regard to relevant customer benefits in considering partial prohibition and divestment.

- 3.25 As with full divestments the Commission will require a partial divestment to be completed within a specified period and may implement additional measures until it takes place. So too the Commission may require any subsequent purchase to be approved.

Regulatory remedies

- 3.26 The Commission will also consider whether to recommend that action be taken by others, in particular the DGWS. This could include changes to the merging companies' price caps and licence conditions requiring the provision of information to the DGWS.

Relevant customer benefits

- 3.27 In deciding remedies³⁵ the Commission

“... may, in particular, have regard to the effect of any such action on any relevant customer benefits in relation to the merger concerned provided that -

- (a) a consideration of these benefits would not prevent a solution to the prejudice concerned; or*
- (b) the benefits which may be expected to accrue are substantially more important than the prejudice concerned.”*

- 3.28 Relevant customer benefits are limited to benefits to “relevant customers” in the form of³⁶:

- “(a) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom; or*
- (b) greater innovation in relation to such goods or services;”*

³⁵Para 4(1) and (2) of Schedule 4ZA to the WIA inserted by section 70 of the Act. The Secretary of State may provide in Regulations for other matters to which the Commission must have regard (paragraph 4(3) of Schedule 4ZA to the WIA). At the date of first publication no such regulations have been made.

³⁶Para 7(1) of Schedule 4ZA to the WIA, inserted by section 70 of the Act.

3.29 Relevant customers³⁷ are customers of the merging enterprises at any point in the chain of production and distribution and are therefore not limited to final consumers and include future customers. It would therefore be a relevant benefit of a merger if, as a result of the merger, a customer in an intermediate market obtained lower prices (or higher quality) whether or not final consumers were likely to benefit.

3.30 In addition to falling within the description of customer benefits described in paragraph 3.26 above, the Commission must believe that the benefit has accrued as a result of the merger, or is expected to accrue within a reasonable time period as a result of the merger, and that the benefit was, or is, unlikely to accrue otherwise.³⁸ The burden is upon the merging parties to provide evidence that any claimed benefit does in fact fall within the meaning of a relevant customer benefit.

3.31 The Commission will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit.

3.32 In the paragraphs below, examples of possible relevant customer benefits are given, followed by an explanation of how they will be taken into account when considering whether any remedial action should be taken.

Possible relevant customer benefits

3.33 A merger can lead to cost savings due to economies of scale in the supply of water and/or sewerage services. The Commission will assess both the extent of the expected cost savings and the extent to which any such cost savings can be expected to lead to relevant customer benefits by being passed on to the merged company's customers through lower price caps.

³⁷ Para 7(4) of Schedule 4ZA to the WIA, inserted by section 70 of the Act.

³⁸ Para 7(2) or (3) of Schedule 4ZA to the WIA, inserted by section 70 of the Act.

3.34 In assessing whether the merger is likely to lead to relevant customer benefits, the Commission considers that relatively little weight can be attached to mere forecasts of future cost savings that would hypothetically be passed on to customers at future periodic reviews. It is likely that much more weight can be attached to anticipated cost savings which are supported by immediate proposed amendments to companies' price caps. Where this is the case, customer benefits accrue in the short term as well as the longer term. In normal circumstances, the Commission will also expect customer benefits to be secured for five years through adjustments to the terms of the companies' rolling incentive mechanisms³⁹. The Commission will also consider evidence on the details of how cost savings may be achieved by the merging companies. This will help to show whether or not cost savings are likely to continue beyond the initial five year period.

3.35 A relevant customer benefit may also result from higher quality or greater innovation. Possible examples of higher quality may arise from improved security of supply due to improved coordination between companies or improved service standards due to additional investment partially or wholly outside regulated capital value. However, before deciding that the benefit is a relevant customer benefit, the Commission would have to be satisfied that it would be unlikely to accrue without the merger or a similar prejudice to the DGWS; for example, that it would not be achieved through agreement between the parties.

Relevant customer benefits and remedies

3.36 If the Commission is satisfied that relevant customer benefits would result from a merger that also led to an adverse outcome, it will consider whether the prejudice concerned can be remedied, mitigated or prevented while taking these benefits into account or whether these benefits may be expected to be substantially more important than the prejudice. If the first circumstance is applicable, the Commission will, wherever possible, seek to choose remedial action that would not adversely affect the relevant customer benefit. However,

³⁹ The DGWS's existing rolling incentive mechanisms are set out in *A further consultation on incentive mechanisms: Rewarding outperformance and handling under-performance of regulatory expectations*, OFWAT consultation paper, 24 June 2003.

the existence of consumer benefits should not prevent the Commission from seeking to remedy the prejudice concerned unless such benefits substantially outweigh the prejudice concerned.

- 3.37 It may be that, to prevent the prejudice concerned, the only effective remedy would be for the Commission to prohibit the merger. The Commission would then consider whether the relevant customer benefits were substantially more important than the prejudice concerned, in which case the merger should be allowed to proceed. It is difficult to quantify the prejudice to the DGWS's ability to make comparisons and, in most cases, the Commission will therefore make a qualitative comparison of that prejudice and the relevant customer benefits in deciding whether the latter is substantially more important than the former.

Undertakings and Orders

- 3.38 As far as its own actions are concerned, the Commission will have the choice of seeking undertakings from the persons that are to be the subject of the remedial measures or of making an order. A relevant consideration in determining which form to use will be the parties' willingness to negotiate and agree undertakings in the light of the Commission's report. Another will be the scope of the Commission's powers and whether the remedy that it considers appropriate falls within those powers.

- 3.39 The Commission's order-making powers are set out in the Act. Schedule 8 sets out the types of provisions that could be included in an order, and Part 1 of Schedule 9 sets out provision enabling the Commission to modify, by order, licence conditions in various regulated markets. While the content of any orders made by the Commission is limited by the Act, the subject matter of an undertaking is not similarly limited⁴⁰. The process of negotiation that is involved with undertakings and the fact that their content is not limited to the matters contained in Schedule 8 may be advantageous in terms of flexibility and suitability. If the Commission decided to exercise its power to modify a relevant licence condition, it would do so by making an order.

⁴⁰ Section 89(1) of the Act as applied to water merger references by regulation 2 of The Water Mergers Regulations.

3.40 In general the Commission's decision as to which form of remedy to use will be determined by issues of practicality. When the particular circumstances of the case point to the need for action to be taken speedily, the Commission may choose to implement the remedy by way of an order to avoid delay while undertakings are negotiated.

3.41 The Commission welcomes the possibility of accepting undertakings that the parties put forward as being those they are willing to enter into and which the Commission considers would provide a comprehensive solution. However, even if the parties do propose undertakings, the Commission may consider alternative remedies.

Procedural and other aspects of undertakings and orders

3.42 For more information about undertakings and orders and the procedure that applies when remedies are being considered see *CC4: General Advice and Information* Parts 6 and 7.

Information relevant to the Enterprise Act

Competition Commission publications

www.competition-commission.org.uk

CC1 *Competition Commission: Rules of Procedure*

CC2 *Merger References: Competition Commission Guidelines*

CC3 *Market Investigation References: Competition Commission Guidelines*

CC4 *General Advice and Information*

CC5 *Statement of Policy Penalties*

CC6 *Chairman's Guidance to Groups*

CC7 *Chairman's Guidance on Disclosure of Information in Merger and Market Inquiries*

CC9 *Water Merger References made under Section 32 of the Water Industry Act 1991: Competition Commission Guidelines*

OFT publications

www.ofc.gov.uk

OFT 508 *Overview of the Enterprise Act*

OFT 506 *Mergers: Substantive Assessment*

OFT 526 *Mergers: procedural guidance*

OFT 501 *Market Investigation References*

Competition Appeal Tribunal publications

Competition Appeal Tribunal Rules www.catribunal.org.uk

Department of Trade and Industry Information

See DTI web site www.dti.gov.uk/ccp