

10 Conclusions

Introduction

10.1. This is the first reference made under section 29 of the Water Act 1989 (the Water Act) (Appendix 1.2). This section, expressed very generally, requires the Secretary of State¹ to refer to the MMC mergers or arrangements in progress which would result in the merger of two or more water enterprises where (among other conditions) the value of the assets taken over exceeds the level set for the time being (currently £30 million) in section 64(1)(b) of the Fair Trading Act 1973 (the 1973 Act). Under the terms of a reference (Appendix 1.1) made on 7 September 1989 we are therefore required to investigate and report on arrangements which it appears to the Secretary of State were in progress which, if carried into effect, would result in a merger of two or more enterprises as defined in section 29(2) and (9)(b) of the Water Act, in that water enterprises carried on by The Colne Valley Water Company (Colne) and Rickmansworth Water Company (Rickmansworth) would cease (within the meaning of Part V of the 1973 Act) to be distinct from water enterprises carried on under the control of General Utilities PLC (GU).

10.2. Before we consider the terms of reference it is necessary for a proper understanding of what follows to explain the structure of the water industry, the main purposes of the Water Act and the circumstances leading up to the reference.

10.3. The evolution of the water industry in England and Wales is described in Chapter 2. For the purposes of our conclusions it is sufficient to understand that in 1973 the industry was reorganised with the setting up of ten regional water authorities (WAs) for England and Wales on the principle that a single body should plan and control all uses of water within the catchment of each major river. The WAs also became responsible in 1973 for sewage treatment and disposal throughout the whole of their areas and operationally for the treatment and supply of water in those parts of their areas not already supplied by statutory water companies (SWCs).

10.4. The WAs were public utilities but the SWCs were, in most cases, the successors, by a process of Government-approved mergers, of companies set up in the 19th century under private Acts of Parliament to supply water in certain areas of England and Wales. The SWCs operated with a mixture of ordinary and preference stock. As they had been granted what were effectively monopolies for the supply of water in their areas some control over their activities was considered to be necessary. Prior to the implementation of the Water Act provisions in relation to SWCs, this control was by means of statutory limits on the dividends they could pay their stockholders, on the amounts they could borrow and on the amount of profit which could be placed to reserve. The effect of these restrictions has been to exercise some check on charges to users but the SWCs, with mature assets and a sound income stream, have generally been able to pay dividends at their permitted maximum.

¹This duty is exercised by the Secretary of State for Trade and Industry.

10.5. The Water Act implemented the Government's proposals for the privatisation of the water industry. The Act provided for the dissolution of the WAs. Their regulatory and environmental functions were withdrawn and their responsibilities for water supply and sewage treatment were passed to the ten Water Services Public Limited Companies (WSPLCs) which were privatised towards the end of 1989.

10.6. The Water Act also established a framework for the regulation of the water industry in England and Wales. It provided for a system of appointments for the WSPLCs and SWCs as water undertakers, the creation of a National Rivers Authority, and for the appointment of a Director General of Water Services (DGWS). A form of regulation has been established which sets standards and limits price increases for each water undertaking throughout the industry. The regulatory system prohibits any increase in water charges beyond the aggregate of the rate of increase in the Retail Price Index and an adjustment factor, known as K,¹ which has been fixed for an initial period of ten years.

10.7. It is fundamental to the principle of 'yardstick' competition (see Appendix 2.1) that the effectiveness of the DGWS's role, which we discuss later, will depend upon his ability to obtain sufficient comparative information about companies, defined in the Water Act as water enterprises carrying on business as water undertakers. Accordingly Parliament decided during their consideration of the Water Bill to add sections 29 and 30, which place a duty on the Secretary of State to refer certain mergers between water enterprises to the MMC.

10.8. The Water Act provided for the 29² remaining SWCs to be brought under the same form of financial regulation as the WSPLCs. The SWCs are allowed by provisions in the Water Act (sections 101 and 102) to convert from their current status to plcs subject to the consent of their shareholders and subject to certain safeguards for minority shareholders.

10.9. Prior to the announcement of the Government's intention to privatise the water industry, investments in SWCs, including ordinary voting stock, had been held mainly for yield and we understand that it was normal practice for shareholders to leave their directors and managements to run the companies without interference.

10.10. When it became clear that the SWCs were to be included in the privatisation arrangements, a small number of French and United Kingdom companies with existing interests in the supply of water, and also some individual investors, took the opportunity of purchasing shares in the expectation that dividend controls would be relaxed and that there would be opportunities to use the SWCs as vehicles for other activities. We have shown in Figure 2.3 that there followed a significant increase in the price of shares in SWCs.

10.11. The investment by certain French and United Kingdom companies, including the WSPLCs, in SWCs has continued to increase and Table 10.1 shows what we understand to be the holdings of major shareholders in SWCs shortly before our report was completed.

¹K can be positive, negative or zero.

²There were 29 SWCs when we commenced our inquiry; during the course of the inquiry Sutton District and East Surrey converted to plc status.

TABLE 10.1 Shareholdings in SWCs

<i>Company</i>	<i>Shareholder</i>	<i>Shareholding %</i>
<i>Anglian Region</i>		
Cambridge	University/directors/employees	66.0
East Anglian	Lyonnais	89.4
Essex	Lyonnais	98.4
Tendring Hundred	CGE*	79.2
<i>Northumbrian Region</i>		
Hartlepool		
Newcastle and Gateshead	Lyonnais	99.4
Sunderland and South Shields	Lyonnais	99.2
<i>Severn Trent Region</i>		
East Worcestershire	Biwater	85.8
South Staffordshire	CGE	29.9
<i>Southern Region</i>		
Eastbourne	SAUR	74.5
	Southern Water	25.0
Folkestone and District	CGE	72.6
	Southern Water	25.0
Mid Kent	CGE	29.8
	SAUR	19.5
	WASA**	15.2
	Prudential Assurance	12.5
	Equity & Law Assurance	5.4
<i>Mid-Sussex</i>	SAUR	71.8
	Southern Water	25.1
Portsmouth	Portsmouth Water Co Pension Fund	84.3
West Kent	SAUR	72.2
Southern Water		24.7
<i>Thames Region</i>		
Colne	CGE	28.2
	SAUR	25.2
	Bank of Scotland Nominees	11.1
East Surrey	AIPF	28.5
Lee	CGE	99.3
Mid Southern	SAUR	99.9
North Surrey	CGE	98.6
Rickmansworth	SAUR	29.9
	CGE	16.1
Sutton District	AIPF	13.7
<i>Welsh Region</i>		
Chester		
Wrexham and East Denbighshire	SAUR	12.2
<i>Wessex Region</i>		
Bournemouth & District	Biwater	98.0
Bristol	CGE	29.9
	Lyonnais	18.0
Cholderton & District		
West Hampshire	Biwater	79.0
<i>Yorkshire Region</i>		
York	Equity & Law Assurance	25.8

Source: MMC from companies' data.

*Shareholdings held in the United Kingdom by GU.

**Water Authorities Superannuation Fund.

10.12. Compagnie Générale des Eaux (CGE), which is the largest company in France involved in the supply of water, has, as will be seen from Table 10.1, acquired shareholdings in a number of water companies and controls Lee Valley Water Company (Lee) and three other SWCs (Folkestone and District, North Surrey and Tendring Hundred). CGE's holdings in the United Kingdom are held through its wholly-owned United Kingdom subsidiary GU. GU has holdings in two other water companies, Colne and Rickmansworth, which are contiguous to and associated with Lee, in relation to some of their supplies of water. It also has holdings in the South Staffordshire, Mid Kent and Bristol water companies.

The merger situation

10.13. We discuss later the circumstances in which the Boards and managements of Colne, Lee and Rickmansworth have, for a number of years, been considering a merger. We have been told that the three Boards decided in the spring of 1989 that it would now be appropriate to bring forward the arrangements for a merger. After consultation with GU, Three Valleys Water Services PLC (Three Valleys) was set up as a vehicle for the merger proposals with the intention that, if the merger took place, Three Valleys would become the controlling shareholder of Colne, Lee and Rickmansworth and manage the new group (see Chapter 4). The merger was to be carried out by means of share exchanges which would result, on the basis of preliminary valuations of Colne, Lee and Rickmansworth and if the share exchange was accepted, in GU becoming the majority shareholder of Three Valleys with between 50 and 60 per cent of the voting shares. The provisions of sections 29 and 30 of the Act apply only to mergers between water enterprises, that is enterprises which have been granted an appointment under the Water Act. GU and Three Valleys do not hold such appointments and are therefore not water enterprises. Lee is controlled by GU, while Colne and Rickmansworth, with no individual shareholder having sufficient shares to give management control, are managed independently by their individual Boards.

10.14. As a result of the merger proposals it is intended that Colne, Lee and Rickmansworth will be jointly managed by Three Valleys and indeed, as we discuss later, that at some time in the future Three Valleys should be granted an appointment under the Water Act which would involve relinquishment of the separate appointments for Colne, Lee and Rickmansworth. Since, if the merger proposal under consideration goes ahead, Three Valleys will be controlled by GU, we are satisfied that arrangements are in progress which, if carried into effect, will result in the water enterprises carried on by Colne and Rickmansworth ceasing to be distinct (within the meaning of Part IV of the 1973 Act) from water enterprises carried on under the control of GU.

10.15. The assets of Colne and Rickmansworth each exceed £30 million (Appendices 3.1 and 3.2, Table 2 in each case) and the condition set out in section 29(3)(b) of the Act is therefore met in this case. We are satisfied also that in this case the conditions in section 29(3)(a) and (c) are met.

10.16. We conclude, therefore, that arrangements are in progress which, if carried into effect, would result in the creation of a merger situation qualifying for investigation. We would add that, as will appear later (paragraph 10.29), we have not found it necessary to consider the question of whether GU has already the ability to control or materially to influence the policy of Colne or Rickmansworth. Even if this were the case, our conclusion as to the creation of a merger situation qualifying for investigation would be unaffected, by reason of the provisions of section 65(4) of the 1973 Act, which are made applicable by virtue of section 30(1) of the Water Act.

10.17. It is evident from the other shareholdings of GU, including those that give it control of the Folkestone and District, North Surrey and Tendring Hundred water companies, that, as a result of the merger situation we have identified in paragraph 10.16, other merger situations might be created in relation to, for example, Colne and North Surrey. As will appear, a number of legal issues have arisen in this inquiry, on which we have sought the advice of leading counsel. On this present point we have been advised that it is not our duty to investigate such possible merger situations with a view to establishing whether these also constitute merger situations qualifying for investigation. We have further been advised, however, that, even if we do not make such formal findings, it would be appropriate for us to consider the public interest consequences in respect of the other water enterprises which may be under the control of GU.

10.18. We have decided to adopt this approach and have not investigated whether merger situations qualifying for investigation would be created in relation to other water enterprises in which GU has holdings. But, as will be evident from later paragraphs of this chapter, we have taken these holdings into account in considering the public interest issues which have arisen in this inquiry.

The interpretation of section 30(3)(a) and 30(6) of the Water Act

10.19. The interpretation of certain aspects of sections 29 and 30 of the Water Act, the extent to which the public interest provisions of the 1973 Act apply to references under section 29, and our duties under the terms of reference have given rise to issues of some complexity. We refer to the evidence of CGE, GU, Three Valleys, Colne, Lee and Rickmansworth (the parties) in some detail in Chapter 9 and set out in this chapter only so much of their views as is necessary for an understanding of the matter and of our conclusion.

10.20. Section 30(3) provides:

In determining on a reference under section 29 above whether any matter operates, or may be expected to operate, against the public interest the Monopolies Commission

- (a) shall have regard to the desirability of giving effect to the principle that the number of water enterprises which are under independent control should not be reduced so as to prejudice the Director's ability, in carrying out his functions by virtue of this Act, to make comparisons between different such water enterprises.

10.21. The parties represented to us that in the application of section 30(3) the first step appeared to be to decide whether the number of water enterprises under independent control would be reduced by the proposals in question. The parties suggested that this involved the application of section 30(6), which required enterprises that have ceased to be distinct within the meaning of section 65 of the 1973 Act (the relevant provision of Part V) to be treated as one enterprise for the purpose of determining whether the effect of the merger was to reduce the number of water enterprises which were under independent control.

10.22. This interpretation would require the MMC to consider whether, at the date of the reference, the policy of Colne or Rickmansworth was subject to the ability of a person being itself a water enterprise, or owning or controlling a water enterprise, to exercise material influence or control, as mentioned in section 65(3) of the 1973 Act, over such policy. If the MMC found that Colne and Rickmansworth were so subject then, the parties argued, the present merger proposal would not reduce the number of water enterprises under independent control and, as a consequence, the principle in section 30(3)(a) and the provisions of section 30(3)(b) would not apply. It was also their view (with which in any event we do not agree) that, in such a case, the MMC would be neither required nor entitled to consider the public interest aspect further.

10.23. We have considered other possible interpretations of section 30(3)(a). In particular the general approach may be taken that since, under section 29, there must, where the necessary conditions are satisfied, be a reference when two or more water enterprises cease to be distinct, the MMC should be able to have regard to the principle that the number of water enterprises under independent control should not be reduced so as to prejudice the DGWS's ability to carry out his functions. It would therefore not be sensible for section 30 to be so construed that the application of the definition provision in section 30(6) defeated this obligation by producing the result that, in some cases of water enterprises ceasing to be distinct in terms of the 1973 Act, there was no reduction of the number of water enterprises under independent control.

10.24. On this approach section 30(3)(a) should be looked at as aimed, not at the prevention of all particular instances of the number of enterprises under independent control being reduced, but as establishing a principle relating to the consequences of such reduction. On this construction, the MMC's duty, as expressed in section 30(3)(a), is to have regard to this principle; the MMC's concern is not only with the particular reduction resulting from the existence or consummation of a particular merger (ie not solely with a comparison of the numbers of enterprises under independent control before and after a merger respectively) but also with avoiding the risk that, at some time in the future, the number of enterprises under independent control might become too small for the making of useful comparisons.

10.25. Section 30(6) would enable the MMC to establish, where necessary, as a general matter or as regards a particular merger under consideration, how many enterprises remained, or would remain, under independent control. The word 'wherever' (two or more water enterprises count as one for the purpose of the merger provisions of the 1973 Act) in section 30(6) may be of importance and it is an advantage of this approach that it could be applied to instances where the degree of control over a water enterprise progresses from, say, material influence to a controlling interest, as envisaged in section 65(4) of the 1973 Act.

10.26. Leading counsel has advised us about these provisions generally and on the possible constructions of them put forward by the parties (see paragraph 10.21) as well as on the alternative construction described in paragraph 10.23. In the light of his advice we believe that both constructions are tenable and capable of being argued effectively.

10.27. It is evident that the resolution of this question is one of legal difficulty. We have considered carefully the arguments which have been put to us and the advice which we have received. While we appreciate the force of the argument put forward by the parties, we have concluded that, in view of the doubt which we believe to exist as to the correct construction of section 30(3)(a), our proper course, in this, the first reference of its kind and in the circumstances generally, is to adopt the alternative approach, as giving the greater potential scope for the application and consideration of the principle established.

10.28. We have taken into account, with future effects in mind, the extent to which the 29 SWCs appear to be at present under the control of, or subject to some degree of influence from, other water enterprises. Table 10.2 sets out the major shareholdings in the 29 SWCs by other water enterprises in January 1990. It shows that 15 were already under the control of four major groups: Biwater, CGE, Lyonnaise and SAUR. A further six, including Colne and Rickmansworth, have as major shareholders other water enterprises, mainly the four major groups, and only seven or perhaps eight SWCs appear to be totally independent. If one then takes into account the ten WSPLCs, on the basis of the parties' contentions, only 17 or 18 water enterprises can be said to be fully independent. This is not to say that for the purpose of section 30(3)(a) it would be correct to assume that there are at present only 17 or 18 comparators. It is our view that each case in which there is a change in the degree of material influence or control over policy, for example from material influence to control, needs to be examined to look at the effect of the change on the ability of the DGWS to make comparisons.

TABLE 10.2 Control and major shareholdings of water enterprises in SWCs

	%
Biwater	
Control:	
Bournemouth & District	98.0
East Worcestershire	85.8
West Hampshire	79.0
CGE*	
Control:	
Lee	99.3
North Surrey	98.6
Tendring Hundred	79.2
Folkestone and District	72.6
Major shareholdings:	
Bristol	29.9
South Staffordshire	29.9
Mid Kent	29.8
Colne	28.2
Rickmansworth	16.1
Lyonnais	
Control:	
Newcastle and Gateshead	99.4
Sunderland and South Shields	99.2
Essex	98.4
East Anglian	89.4
SAUR	
Control:	
Mid Southern	99.9
Eastbourne	74.5
West Kent	72.2
Mid-Sussex	71.8
Major shareholdings:	
Rickmansworth	29.9
Colne	25.2
Mid Kent	19.5
Southern	
Mid-Sussex	25.1
Eastbourne	25.0
Folkestone and District	25.0
West Kent	24.7
<i>Companies with no water enterprises shareholdings above 20 per cent</i>	
Cambridge (66.0% holding by university/directors/employees)	
Chester	
Cholderton & District	
East Surrey (28.5% holding by AIPF)	
Hartlepoons	
Portsmouth (84.3% holding by Portsmouth Water Co Pension Fund)	
Sutton District	
York	
Wrexham and East Denbighshire (12.2% holding by SAUR)	

Source: MMC from companies' data.

*Shareholdings are held in the United Kingdom by GU.

Note: Figures are shares of voting stock.

10.29. Because of our conclusion on this matter, set out in paragraph 10.27, we have not found it necessary to carry to a conclusion the second stage of the procedure suggested by the parties' argument, ie to reach a decision on whether the policy of Colne and Rickmansworth is subject to the ability on the part of a water enterprise or a person which owned or controlled a water enterprise, to exercise material influence or control of such policy. From our preliminary examination and consideration it is clear that there are substantial shareholdings in both companies by, amongst others, GU and SAUR. On the basis of the evidence given to us, however, particularly in relation to the failure of SAUR to gain representation on the Board of Rickmansworth, and the lack of consultation

by the Boards of Colne and Rickmansworth with either GU or SAUR in relation to the merger proposals, it is not clear that material influence or the ability to exert material influence over or control of policy necessarily exists.

10.30. We have also had regard to what is apparent from the separate evidence of Colne and Rickmansworth, and to a lesser extent Lee, that at present and in the future, if the merger is not allowed, the Boards and management of the three companies are and will be making separate and independent decisions on investment and operational matters.

10.31. As a consequence of the merger which we are investigating, the number of water enterprises under the control of GU will be increased and the number of water enterprises which are making separate and independent management decisions will be reduced. We have therefore decided that it is proper for us to take account of section 30(3) in reaching our conclusions.

10.32. Two further points of construction have arisen in relation to section 30(3)(a). The first relates to whether, given a reduction or prospective reduction in the number of water enterprises under independent control, it is the duty of the MMC to consider whether this would be such as to prejudice the ability of the DGWS, in carrying out his functions under the Water Act, to make comparisons between different water enterprises. This, in turn, involves the weight to be given to the maintenance of the maximum number of comparators and to the views of the DGWS in relation to the effects of the merger and his duties under the Act.

10.33. We have been advised and are satisfied that it is our duty to consider the questions set out in paragraph 10.32. In doing so, while giving due weight to the evidence of the DGWS, we must have regard in each case to all the relevant evidence about the number and quality of comparators. Section 30(3)(a) does not, we believe, create a presumption that evidence by the DGWS to the effect that the loss of comparators, as a result of a particular merger, would prejudice his ability to make comparisons must necessarily outweigh other evidence on the point which we receive from any quarter.

10.34. The second point of construction (see paragraph 10.32) is whether the matters in section 30(3)(a) should be considered separately from those in section 30(3)(b)(i) and (ii). Having regard to the advice we have received, this is in our view the case; sub- paragraphs (b)(i) and (ii) would need to be considered only if we should find the merger would result in such prejudice. Such a finding would not, however, exclude further consideration of the public interest under section 84 of the 1973 Act (see further, paragraph 10.105).

10.35. We have therefore to decide whether, in our view, the proposed merger would involve such a reduction in the number of water enterprises under independent control as to 'prejudice the Director's¹ ability in carrying out his functions ... to make comparisons between different such water enterprises'. We have formed the view, after taking advice, that our approach to this particular question should be one of principle, rather than one based solely on numbers. This involves the consideration of the DGWS's role and what has become known as 'yardstick competition'.

The DGWS's role

10.36. The water industry has features which make the supply of water a 'natural monopoly'. This means that delivering water through a fixed network of pipes is most efficiently organised by a single company in each area, rather than by a number of companies competing to attract customers. There may be some competition to supply new customers on the boundaries between supply areas (inset appointments), but this is likely to be extremely limited. In practice, customers will only have one company from which they can get their essential supply of piped water and there is no likelihood of competition in supply developing.

10.37. This situation is in contrast to some of the other recently privatised industries where customers may have a degree of choice of suppliers (for example, between British Telecom and

¹ ie the DGWS's.

Mercury) or may be able to switch from using one product to a substitute supplied by another company (for example, by switching from gas to electricity or coal). Where, as in the case of water, there is no competition in supply and no possibility of substituting other products, the requirements for regulation of the industry are different, and arguably even more important, than in sectors where some element of competition exists.

10.38. In order to overcome this lack of competitive pressure, the Government has sought to create a regulatory framework to act as a surrogate for the operation of a free market and thereby subject companies to similar pressures to those which arise from competition. By establishing a price adjustment formula and comparing individual company performance in line with the principle of yardstick competition (see Appendix 2.1) the regulator would limit the level of possible price increases yet provide companies with an incentive to cut costs and improve efficiency.

10.39. The first stage of this process, which took place in 1989, was the establishment of a price adjustment formula, $RPI + K$, with individual levels of K being set for each of the ten WSPLCs and 29 SWCs by the Department of the Environment (DoE). DoE took account of the relative efficiency of each company and a range of other factors affecting their performance, examined the costs of meeting future quality standards, capital expenditure, proposed levels of service and levels of expenditure in such matters as customer care. In view of the number of variables considered in establishing K for each company, it is perhaps not surprising, as is clear from the evidence of DoE, that there has been a considerable degree of negotiation in the K -setting process, both in relation to individual companies, and in establishing broad principles for different sectors of the industry. After the initial K s have been determined, the responsibility for conducting periodic reviews of K will, under the provisions of the Water Act, pass to the DGWS.

10.40. The DGWS discussed with us the general principles he proposes to adopt and the way in which he expects the implementation of yardstick competition to work in practice. He explained that he proposed to make comparisons across a wide range of performance measures but that interpretation of such comparisons would involve a considerable element of judgment. Thus, he argued, the more and varied the approach adopted by individual companies to the many problems facing the water industry, the better the opportunity for him to consider the success and costs of the methods adopted by different managements and to take them into account when reviewing levels of K at ten- (or in some circumstances five-) yearly intervals. The argument that, in the absence of competitive pressures, regulation via yardstick or comparative competition should not rely solely on a purely quantitative analysis of relative costs, but on a much wider examination of the factors affecting particular companies and the industry as a whole, seems to us to be reasonable.

10.41. In the present stage of the development of yardstick competition, when the structure of the industry and particularly the ultimate ownership of the SWCs may be subject to change, the concern of the DGWS that he should not be required to regulate by reference only to a small number of comparators can be understood. The DGWS has also argued that his ability to make comparisons should not be limited to the relatively small number of observations that might be sufficient purely to test the statistical significance of external factors that might affect company performance.

10.42. The DGWS has also drawn attention to the difference between the information which may be derived from a wholly independent water undertaking, compared with one which, whilst having a degree of independent management, may be subject to the overall control of a large group. He also distinguished between information which may be derived from cost centres or from profit centres within a single organisation, whether independently managed or part of a large group. In his view profit centre rather than cost centre data would be more helpful for his purposes because they would arise from a fuller consideration of the appropriate cost allocation and transfer pricing arrangements.

10.43. Looking generally at the water and sewerage industry, it appears that there may be benefits to be derived from its recent association with large companies, either French or United Kingdom-based, which, in terms of water industry expertise or management capabilities, have much to offer individual SWCs or even WSPLCs. There may also be a cost to the extent that such concentration leads to a reduction in the number of observations that the DGWS has available for comparative purposes. Moreover, another concern expressed about the way in which yardstick competition may be undermined is that the smaller the number of firms in the industry, the easier it would be for them to adopt common standards and consolidate negotiating power vis-à-vis the

regulatory authority. The ability of the DGWS to carry out his duties in relation to periodic reviews of K could thus be further adversely affected.

10.44. The water industry faces various difficult problems. In many areas of the country demand is increasing, existing water resources are sometimes fully used and there is a growing problem of pollution. The role of the DGWS will be vital in maintaining a balance between the requirement that all undertakings should be able to achieve adequate returns on their capital, and ensuring that all customers are supplied with good quality water at a reasonable price. Achieving this balance is an essential feature of the regulatory framework and we do not underestimate the difficulties facing the DGWS. Considerable weight must therefore be given to his evidence that the successful achievement of this balance is dependent upon his ability to make comparisons, and that any reduction in the number of comparators will adversely affect his ability to do so.

10.45. On the other hand, some mergers may have only slight effects on the DGWS's ability to make comparisons and may even result in a better comparator becoming available. Each merger considered under section 29 must therefore be examined on this and other aspects in relation to its particular circumstances and our conclusions must take account of these circumstances.

The Three Valleys merger

10.46. Colne, Lee and Rickmansworth are SWCs operating in an area to the north of London see Appendix 2.3. Each of the companies has been significantly enlarged over the last 30 years as a result of a series of mergers with other SWCs and local authority water undertakings. The area which the three companies supply was originally provided with water from aquifer sources and much of the supply continues to come from such sources. The extent of demand has, however, entailed the need to obtain water from outside the areas served by the companies. Lee has a long-standing arrangement with Anglian Water Plc by which water is extracted from the Grafham Water scheme.

10.47. In the late 1960s, the companies told us, it became clear to Colne and Rickmansworth that their aquifer resources were becoming inadequate. They decided to extract water directly from the River Thames and were joined in what became known as the Three Valleys Water Committee by Lee, although at that time Lee had no requirement for additional water (paragraphs 3.20 to 3.22). The Three Valleys Water Committee is managed jointly by the three companies; it operates the Iver Treatment Works which obtains its water from the River Thames. Water from Iver is becoming increasingly important to Colne and Rickmansworth and Lee has notified the Committee that it also expects to need to take water from the Iver scheme in the early 1990s. This will require a major extension, which has been long planned, to the Iver plant and the construction of new mains to serve Lee.

10.48. The parties told us that there had been for many years close working relationships between the companies, with joint operating arrangements and more recently a number of joint directorships. Since 1988 the same person has been Managing Director of both Colne and Rickmansworth. The two companies told us that they continue to be separately managed and operated.

10.49. Merger proposals for the three companies had been considered for some years but, we were told, had not come to fruition. This was partly because of the regulatory environment which, since 1973, had given the companies concern that a merger might lead to a proposal to amalgamate their operations with Thames Water, and partly because of the personalities involved. The introduction of the new structure and financing arrangements for the water industry has acted as a spur to the companies in bringing forward merger proposals. This led, during 1989, to the formation of Three Valleys and to the detailed arrangements for the merger (see Chapter 4).

10.50. The parties told us that, as independent plcs operating as water undertakers under the new regulatory regime, the scope for future joint initiatives between the three companies would be very limited, and that even the continuation of existing links would be difficult to ensure. In these circumstances they submitted that the only practical means of securing this much-needed evolution in their relationship was through common ownership and management. The parties claimed that substantial benefits would flow from the merger, ultimately to the benefit of customers. The benefits (see paragraph 9.9) would include more efficient and effective use of water resources, greater security of supply with an efficient and effective use of an integrated supply network, cost savings, increased financial strength and greater ability to embark on new activities closely related to the core businesses from which contributions to the overheads of the existing businesses may arise.

The effect of the merger on the DGWS's ability to make comparisons

10.51. The parties told us that the principle set out in section 30(3)(a) of the Water Act was intended to ensure that the DGWS, in carrying out his functions, continued to derive adequate data from water enterprises so as to be able to compare their efficiency. In their view the proposed merger would not prejudice and might, indeed, enhance his ability to make such comparisons. They put forward three main arguments in support of this view. First, they submitted that by virtue of the joint asset ownership and management arrangements made in relation to the Iver Treatment Works, the three companies did not at present provide three statistically independent comparators. The extent to which they did provide a degree of statistically independent information would decrease over time even if they did not merge. The increasing significance of Iver to the three companies, and the consequent cost-sharing arrangements, would result in the efficiency of the companies becoming increasingly interlinked.

10.52. Secondly, the parties claimed that the merger would create a more efficient water enterprise unit which would be of more value to the DGWS as an indicator of the levels of efficiency achievable. This would avoid the distorting effects of the joint working involved under the present arrangements. A merger would create a group whose size and geographical spread would make it comparable in terms of water supply with the smaller WSPLCs and thus provide a further comparator in the middle range of the larger organisations.

10.53. Thirdly, the parties saw the ability to make comparisons between water enterprises not as an end in itself but in relation to the performance by the DGWS of his functions under the Water Act in a manner calculated to achieve the objectives established in section 7(3) of the Act, in particular to promote economy and efficiency on the part of water undertakers. In so far as the SWCs were concerned, the structure of the water supply industry in England and Wales at the date of the passing of the Act reflected an evolutionary process of growth and acquisition to improve efficiency in the utilisation of resources and infrastructure. The parties submitted that it could not have been intended that section 30(3)(a) of the Act should be interpreted so as to ossify the existing supply structure, however costly or inefficient it was, so that comparative data continued to be available to the DGWS in 50 years' time in the same form as today.

10.54. In these circumstances the parties put it to us that if the DGWS considered that the merger would prejudice his ability to carry out his functions under the Act, it was for him to demonstrate the ways in which prejudice would actually result. If adequate information remained available, in that there was a sufficient number of statistically independent comparators for him adequately to perform his functions, no presumption of prejudice could arise.

10.55. The parties also believed that the scope for any form of competition through inset appointments was, in their case, extremely limited and that the proposed merger would have no significant effect on the possibility of such competition.

10.56. The DGWS accepted that, although there was interest in the possibility of inset appointments, the scope for large-scale competition in the supply of water was always likely to be limited as the water industry was a local monopoly. Consequently, consumers could not generally look to market mechanisms to protect them from unnecessarily high charges or a poor service, or both; the regulatory regime had to seek the same balance between the interests of suppliers of water and consumers as would otherwise be achieved by competitive markets.

10.57. The DGWS explained that the primary mechanism for encouraging efficiency was the price control formula (RPI + K) to be set initially by the Secretary of State for the Environment and periodically reviewed by the DGWS. To ensure that the benefits of greater efficiency were passed on to the consumer, the DGWS would need, when conducting a general review of K factors, to consider not only the future expenditure needs of individual undertakers, but also the scope for further efficiency savings across the industry as a whole and by individual undertakers. The main evidence available to him in judging this would be the improvements in efficiency already secured, and an assessment of the efficiency of individual undertakers compared with the industry as a whole.

10.58. The most obvious, but not the only, form of comparison available to the DGWS would be between the capital and operating costs of different water undertakings, taking account as appropriate of the environment in which they operated. Such comparisons could reveal significant differences, which could be pointers to ways in which some water undertakings might be performing relatively weakly. It was much more likely that the impact of different operational characteristics on performance could be properly identified if there were more observations rather than fewer. The DGWS's interpretation of section 30(3) of the Act was that the number of water enterprises under independent control should not be reduced unless the achievement of other purposes was of a substantially greater significance in relation to the public interest than the principle that the number of enterprises which were under independent control should not be reduced so as to prejudice his ability to make comparisons, and could not be brought about except in a matter which conflicted with that principle. Such 'other purposes' would include cost reductions, but only those which would be secured through a merger, as opposed, for example, to co-operation under normal contract terms. The DGWS considered that the onus of proof should rest with those who considered that the 'other purposes' outweighed the maintenance of incentives to the promotion of efficiency across the rest of the industry.

10.59. The DGWS explained that it was not possible to say with any precision what effect a reduction in the number of undertakers would have on his ability to set taut efficiency targets, because no one could say at this stage how large further efficiency savings would be. He took the view that the better the comparative information available to him, the tauter the efficiency targets he would be able to set. Efficiency savings which averaged 2.5 per cent per year for the first five years had been built into the values of K set for the ten WSPLCs and, ideally, he hoped that targets of the same order might be built into future K values. He told us that, with the present number of comparators, he might expect to be able to set efficiency targets which were perhaps 0.25 to 0.5 percentage points higher than if the number of comparators was materially reduced. Any reduction in efficiency targets resulting from a loss of comparators would have a cumulative effect; thus if annual targets were to be 0.25 percentage points lower then, by the end of ten years, the target level would be 2.5 per cent lower than it would otherwise have been. Over a longer period the cumulative reduction would be greater.

10.60. The DGWS suggested that one way of assessing the effect of the possible loss of comparators as a result of the merger was to compare the value of the cost reductions that the parties claimed would result from the merger with cost reductions that might be lost in the water industry as a whole if his ability to set targets was reduced. We have examined the savings which the parties expect the merger, if it goes ahead, to bring about. These would occur over a period of years and their present value (using the discount rate of 8 per cent applied by DoE in the K-setting procedure) is in the region of £50 million to £60 million (at April 1989 prices). The higher figure includes the value of reduced financing costs associated with improvements in cash flow. These savings are equivalent to around 5 per cent of the three companies' estimated costs if the merger did not go ahead.

10.61. We have looked at the arguments of the DGWS in paragraphs 10.59 and 10.60. The projected discounted costs of the Three Valleys companies account for about 1.7 per cent of the total costs in the industry (including sewerage costs) measured on a comparable basis. If the estimated sewerage costs of the ten WSPLCs are excluded, as seems appropriate since our concern is only with the supply of water, the Three Valleys companies account for about 3 per cent of industry costs and for a similar proportion of revenues. A 5 per cent reduction in the Three Valleys companies' costs, with no change in other water undertakings' costs, would therefore mean that costs for the water industry as a whole would fall by 0.15 per cent. If a reduction in the number of comparators resulting from the merger meant that the cumulative efficiency targets which the DGWS was able to

set over a number of years were reduced by the same percentage, or more, then on the basis of the DGWS's argument the benefits of lower costs in Three Valleys might be more than offset by the loss of efficiency gains in the rest of the industry.

10.62. In the DGWS's view, cost comparisons for the purpose of judging relative efficiency were not the only reason for wanting to maintain the number of separate water enterprises in the industry. Separate management, not necessarily separate ownership, was important for such comparisons. There were, however, equally strong reasons why a reduction in the number of separately owned companies was undesirable, as it would adversely affect the extent of competition for corporate control. The greater the number of undertakers which were separately owned, the greater would be the ability of financial markets to undertake their own comparisons of performance, and the greater the number of potential take-over targets. The DGWS pointed out that the Water Act did not introduce any presumption against mergers except between existing water enterprises and he certainly did not wish there to be any reduction in the threat of take-over as an incentive on managements to operate efficiently. He believed that such capital market considerations might be of even greater significance in the case against mergers and take-overs between existing water enterprises.

10.63. In summary, the DGWS suggested to us that section 30 of the Water Act established criteria for the public interest which were not, to his knowledge, reflected in previous legislation. The burden of proof under the section was, in his view, on those proposing a merger to show that there were substantial gains in terms of reductions in cost which were available to be passed on to consumers, which could not be achieved in other ways, and which outweighed the effects on his ability first to encourage efficiency by comparing the operational and financial performance of water enterprises and secondly to facilitate competition.

10.64. The DGWS told us that he was concerned that the number of independently controlled (as distinct from independently managed) water companies was already significantly lower than 30. It could fall further without the merger provisions of the Water Act necessarily being triggered because of the application of the assets test (paragraph 10.15). His ability to encourage efficiency and facilitate competition and, more generally, to protect the interests of consumers (which were duties laid on him by the Water Act,) could, in the DGWS's view, be jeopardised if the merger was allowed. The direct benefits to consumers of allowing the merger would need to be large and certain to offset this detriment.

10.65. Turning to the detailed views put forward by the parties on the changes that the merger would bring about, the DGWS explained that he did not accept that the operation of the Iver Treatment Works as a joint venture would necessarily prejudice the value of the companies' continued separate existence as comparators. Providing proper cost allocations were made in relation to Iver, their value as independent comparators would be maintained.

10.66. As to the suggestion that the proposed merger would create an enhanced comparator, the DGWS doubted whether this would be the case, unless the merged organisation provided additional information on the scope for greater efficiency in water supply (in other words an observation closer to the efficiency frontier for the industry as a whole); this would depend on the projected savings from the merger as well as a wide range of other variables. He agreed that there might be some amelioration of the loss of his ability to make comparisons if the companies continued to provide, in relation to a merged group, separate information on costs for the areas presently supplied by the existing companies. He told us that if this information was to be valuable to the regulator it would probably require the establishment of separate profit centres.

Our view on section 30(3)(a)

10.67. We have considered the conflicting views of the parties and the DGWS in relation to the latter's role in making comparisons. As we have explained (paragraph 10.33), we do not accept the view of the DGWS that in relation to section 30(3)(a) it is proper to balance any benefits that we may perceive as arising from the merger against the prejudice to his ability to make comparisons. Our view is that section 30(3)(a) must be considered as a distinct matter; the question of balance does not arise at this stage.

10.68. We consider, however, that while the circumstances of the particular merger must always be given substantial weight, it is necessary in reaching a conclusion under section 30(3)(a) also to take into account the overall effect on the industry.

10.69. We have therefore considered the information set out in Tables 10.1 and 10.2. This indicates the extent to which there is already, within a year of the Water Act being passed, a number of major groupings within the industry. No more than eight SWCs can be said to be free from the possibility that a major company, for example a WSPLC, might already be in a position to influence their activities.

10.70. Moreover, while the WSPLCs have been set up with 'golden' shares as a protection against take-overs, except for Welsh Water these are for limited time-spans. The recent decision of the Government to relinquish a similar share in Jaguar suggests that take-overs of WSPLCs might well be possible sooner rather than later.

10.71. While some such take-overs may be by enterprises which are not, or do not already own or control, water enterprises, other proposals, which under section 29 of the Water Act would be referred to the MMC, might involve existing water enterprises and hence, if allowed, increase the trend towards concentration.

10.72. This concentration may already be having an effect on regulation. It has become increasingly clear during the course of the K-setting procedure for the SWCs that these have involved negotiations in which the individual SWCs have been able to look for advice and guidance, not only from their own professional advisers and their Association, but also in some cases from their shareholders with large interests in the water industry.

10.73. The value of yardstick competition in relation to a natural monopoly has in the past been put forward on a theoretical basis and, at least in the United Kingdom, there has been no practical experience of its use in a regulatory context. The application to the water industry of yardstick competition therefore represents a new regulatory departure. The DGWS will be negotiating with water enterprises, not only in relation to K, but also on such matters as 'cost pass through' items and standards of service. To the extent that the information available to him may, by virtue of further concentration in the industry, contain fewer observations from independent undertakings, he will be put at a disadvantage. This disadvantage is likely to be greater if even those enterprises that retain a degree of separate management are themselves advised by a few major industrial groups which have a duty to their shareholders to maximise their profits, and which are therefore likely to co-ordinate the actions and responses, not only of the water enterprises they control, but also of those in which they have an interest.

10.74. GU has already set up what it describes as a 'club', known as the General Utilities Scientific and Technical Organisation (GUSTO), which brings together representatives of the SWCs in which GU has either controlling or minority shareholdings to discuss technical matters of common concern and to promote joint development projects, particularly in the area of water quality. Such co-operation may bring considerable advantages to those who take part and, indirectly, to water consumers. But the existence of a club of this nature, whose activities could easily be extended to co-operation on matters which concern the regulation of the industry, might be prejudicial to the DGWS's role, particularly if the scope of GU's shareholdings and influence grew.

10.75. For the reasons set out above we believe it is appropriate, particularly in the early years of the new structure of the industry, to give considerable weight to the DGWS's view on the prejudice which the loss of comparators would bring to his role. We have also to take account of the fact that

only seven or perhaps eight of the 29 SWCs can be said to be fully independent so that the DGWS has therefore less than 20 absolutely independent comparators.

10.76. This is not to say that in every case it would be appropriate to accept the view that a particular merger may prejudice the DGWS's ability to make comparisons. Moreover, even given a finding of prejudice, it follows from the provision of section 30(3)(b) that there may nevertheless be a conclusion that the merger does not, or may be expected not to, operate against the public interest.

10.77. On the basis of the reasons we have set out above, we have concluded that, while we do not fully accept the extent of the prejudice suggested by the DGWS, the proposed merger involves such a reduction in the number of water enterprises which are under independent control as may be expected to prejudice the DGWS's ability to carry out his functions by virtue of the Water Act to make comparisons between different such water enterprises.

Section 30(3)(b)

10.78. We have already explained that we consider the questions raised by section 30(3)(b) should be considered separately from those of section 30(3)(a). It also appears appropriate for us to consider section 30(3)(b)(i) and (ii) separately.

10.79. In considering section 30(3)(b)(i), while the exact significance of the word 'purpose' is not wholly clear, we consider that it must include the question, which seems to us particularly relevant in the present context, of whether the purposes that are put forward for the merger could be achieved in a way which does not conflict with the principle expressed in section 30(3)(a). This requires us to examine the main purposes of the merger and see whether these purposes could be achieved without conflict with that principle.

10.80. We have already referred to the circumstances in which the DGWS and the parties have suggested that the availability of cost and/or profit information in relation to Colne, Lee and Rickmansworth separately, perhaps as divisions of Three Valleys, would according to the DGWS reduce the prejudice and, according to the parties, eliminate it.

10.81. We take the view that the information, particularly if it relates to profit centres, would reduce the prejudice but could not by itself eliminate it because, inevitably in the circumstances in which the three companies are to be managed as one unit, there would be similarity of purpose and methods in much that is done.

10.82. We also have to consider whether, as the DGWS has submitted, some of the other advantages claimed for the merger might be achieved without the loss of the independence of the water enterprises concerned.

10.83. We are satisfied that the savings in staff which relate to the amalgamation of certain functions carried out by the companies would not in most cases be available without the merger.

10.84. We are less satisfied about the financial and staff savings which arise from the provision of a single laboratory function. The DGWS has submitted that laboratory functions can be, and in some instances are, obtained on an agency basis and that it would be perfectly satisfactory and cost effective for the individual companies to put their work out to laboratories on that basis. The companies have, however, claimed that they would feel unsafe unless they were able to decide their own priorities of work for the laboratories and, given the problems of water pollution that they are likely to face, we have sufficient sympathy with that view to accept that, on balance, the approach they suggest may be the correct one.

10.85. We take a different view in relation to the necessity to set up and maintain a central computer facility for billing functions staffed by Three Valleys personnel. We believe that it would be possible, as indeed is the case with Lee at present, for this to be carried out by contract. We have noted, however, that the companies have themselves said that when it came to setting up the combined facility, they would have regard to the comparative costs and other factors of supplying their own facilities and using central services before deciding on the approach to be adopted.

10.86. The most significant area where savings are claimed, both in staff costs and capital costs, is in relation to the Iver Treatment Works where the companies have put forward plans which would enable delay, and in some cases a permanent reduction, in some aspects of the capital investment that would otherwise be required for Lee to take water from Iver (see Chapter 4). The proposals in relation to the Iver Treatment Works would also allow the merged group, we were told, to make more effective use of its water resources than would be possible if the companies remained separate. The DGWS has submitted that a full merger of the companies is not necessary for the change in plans, but the companies claim that this can only be made when there is a single management of the group of companies, able to co-ordinate and control the water resources centrally.

10.87. The evidence we have received is not entirely conclusive on this matter and it does appear that it might be possible for more economic arrangements to be made without a merger. This would, however, depend on whether the managements of the individual companies were prepared to take the risk that, in such circumstances as a mains failure or a longer-term shortage of resources, they would be able to rely on the fullest co-operation and joint agreement.

10.88. On balance, we take the view that it is unlikely that the more economical Iver scheme could be achieved without the merger because, in circumstances in which managements of the companies would, for the first time, be subject to the pressures of shareholders as well as of users, they would not wish to surrender the freedom of independent action implicit in the necessary sharing of resources.

10.89. The companies have also claimed that certain interest savings may arise from the merger. As these would depend on the larger grouping that would come about as a result of the merger, as well as on the ultimate control by CGE, we do not think that this could be achieved without a merger. Similar considerations apply to the proceeds of the proposed sale of Colne's and Rickmansworth's headquarters.

10.90. The new structure of the industry will bring increased pressure on individual managements to look for economies that improve the efficiency of their enterprises. Some of the savings that have been identified might therefore be achieved without the merger and loss of comparators. We are satisfied, however, that unless the merger goes ahead the greater part of the cost savings would not be achieved and the advantages to the companies and users from the more flexible use of water from the Iver Treatment Works would not be available. We have, therefore, concluded that these purposes of the merger cannot be fully achieved without the merger and, therefore, without avoiding prejudice to the DGWS's ability to make comparisons and consequently, cannot be achieved in a manner which does not conflict with the principle expressed in section 30(3)(a).

10.91. We turn next to section 30(3)(b)(ii), which requires us to consider first whether the achievement of the purposes that are to be brought about by the merger are of substantially greater significance in relation to the public interest than the principle in section 30(3)(a), and secondly whether they cannot be brought about except in a manner that conflicts with that principle. We have already taken the view that if a merger took place Three Valleys could continue to provide the DGWS with information on a cost or profit centre basis in relation to the businesses of the previously independently managed companies, but that the other purposes of the merger, namely staff savings, the rationalisation of laboratory services and perhaps, above all, the reduction in short-term and long-term costs in relation to the Iver Treatment Works, cannot be brought about without the merger. We therefore have to consider whether, and to what extent, the cost savings which the parties consider may be brought about by the merger are of greater significance in relation to the public interest than the prejudice to the DGWS's ability to make comparisons that we have identified.

10.92. We have examined the proposed savings which are set out in Chapter 4 and Appendix 4.1 with the company and have had regard to the views of the DGWS on certain aspects of these savings, particularly his expectation that the merger might give rise to savings in financing costs from being able to raise capital on more advantageous terms.

10.93. The savings which have been claimed are substantial and are made up of reduced operating costs which continue from year to year, one-off savings and savings related to the deferral and cancellation of capital projects. Operational savings would build up over the first five years after a merger and would then continue at a level of about £3.5 million a year. Capital projects could be deferred in the first five years after merger. The principal one-off saving related to the amalgamations of head office functions would occur in the first five years. The discounted value of all of these changes in cash flows is in the region of £50 million (as shown in Appendix 4.1, Annex 2). In addition there would be further savings resulting from reduced financing costs which would put the total discounted value of savings up to around £60 million.

10.94. In terms of the possible effect of these savings on consumers' charges, they must be considered in the context of a group of companies with a turnover in 1989 of some £60 million and capital expenditure plans over the next 15 years of over £600 million. In order, therefore, to assess the significance of the savings, we have considered their effects, on the basis that they all benefited consumers, on the Ks that were notified to the individual companies in the winter of 1989.

10.95. Our estimates indicate that, if the merger were to go ahead and all the savings were applied in reducing K, the reduction for each of the three companies would be in excess of 0.6 per cent. These estimates have arisen from setting equal reductions in K for each of the ten years and do not take account of the peaking of savings and costs which might be taken into account if new Ks were set. The effect on the average user at the end of the ten-year period would be water charges at least 6 per cent lower than if the merger did not take place.

10.96. The DGWS has received a summary of much of the evidence from the parties during this inquiry and has been informed of the nature and amount of the savings claimed. In his view unless these savings were substantial and were translated into lower prices they would not balance the damage which he believes the merger would cause to his ability to set taut Ks for the industry as a whole. In other words, he argues that it had to be demonstrated first that the merger would bring benefits to the consumers within the Three Valleys area, and secondly that these benefits were not simply gained at the expense of users throughout the remainder of England and Wales who might have to pay higher charges because of his inability to set sufficiently taut Ks.

10.97. We have considered this argument carefully and those in paragraphs 10.60 and 10.61 which attempt to quantify the effect of a loss of comparators. While we believe that the evidence supports the view that the proposed merger would prejudice the DGWS's ability to make comparisons (see section 30(3)(a)), we consider that, at this stage of the introduction of 'yardstick' competition for the water industry, the lack of certainty of the ways in which the system will develop makes it difficult to quantify the loss of comparators accurately in financial terms. We have also taken into account the fact that some of the benefits of the merger will accrue in the early years whereas the DGWS's use of comparators will apply only when K values are reviewed in the future.

10.98. An additional unquantifiable factor in this case is the existence of the Iver Treatment Works which will enable the new group to allocate its water resources more effectively with advantages to the users in terms of security of supply as well as in reduction of costs.

10.99. There are, however, other matters to be considered. While the parties have claimed that the savings can be achieved, they depend on the implementation of the integration plans. For example, further advice might suggest to the managers that it would be best, perhaps for security reasons, to revert to the previous and more costly Iver scheme even if the merger does take place. Moreover, while the companies appear to accept that users should benefit, there is no mechanism for ensuring that this will happen until a review of K occurs. We consider that if the purpose that outweighs the prejudice is related to cost savings, in circumstances where there is no effective competition, the savings must be assured ones and should benefit the users and not be retained by companies concerned.

10.100. The parties have also claimed that the merger will, because of the size of the combined group and its association with CGE, bring other benefits (see paragraph 10.50), including a greater ability to embark on new activities closely related to the core business which would reduce overheads. This is a possibility but no detailed plans have been put to us. In any event, we consider that the benefits that may arise from new activities would not be such as could be taken into account in relation to the balance between the other purposes of the proposed merger and the prejudice to the DGWS that we have identified.

10.101. We are required by section 30(3)(b)(ii) of the Water Act to have regard to the desirability of achieving other purposes only so far as we are satisfied that they are of substantially greater significance than the principle that the number of water enterprises under independent control should not be reduced so as to prejudice the DGWS's ability to make comparisons. This requires us to balance the prejudice to the DGWS's ability that we have established against the benefits that are claimed for the merger. While, as we have explained, the extent of the prejudice is difficult to quantify, we recognise that it could affect all water users in England and Wales through its effect on the setting of future K values. On the other hand the benefits—the unquantifiable future benefits affecting consumers including better use of the Iver Treatment Works and the cost savings affect only the users in a small part of England.

10.102. We have therefore to balance the prejudice we have established in terms of its likely effect on the future charges of all consumers of water in England and Wales, which we have been unable to quantify with any certainty, against the quantifiable benefits of the merger. If we could be reasonably confident that consumers in the Three Valleys area could expect over the next decade or so to have substantial reductions in the level of their charges and, at the same time, be assured that, with the greater flexibility of supply from Iver, future demands of water could be met more economically and with greater certainty, it would be difficult to put these benefits aside in the hope that the DGWS might achieve greater savings for a larger number of consumers if the merger were stopped. Until the DGWS is in a position to demonstrate the adverse effects of the loss of comparators from experience in the setting of Ks, we believe that it is difficult to set aside significant cost savings and improved efficiency in the hope of future theoretical benefit.

10.103. In this case, however, while the parties have confidently claimed that substantial savings will follow a merger, we cannot be sure that such savings will be made in practice or, if they are, be passed on to consumers. This could only occur, unless by way of voluntary act by the companies concerned, if the companies gave a formal undertaking or if the Ks were adjusted for the present companies to take account of the benefits or if a new appointment and thus a new K was made for the Three Valleys company. It is possible therefore that if the merger took place, either the savings would not be achieved, because of change in mind of management or changing circumstances, or they would not be passed on to users. We consider that if we were to conclude that the benefits arising out of the merger including the cost savings were of substantially greater significance in relation to the public interest than the principle of comparison, it could only be in circumstances in which benefits claimed by the parties could be confidently expected to benefit the users in the area served by the three companies. We do not think that in the present circumstances, where (see paragraph 10.113) the DGWS has no power to require a new appointment and hence a re-evaluation of K for Three Valleys, we could confidently expect that the claimed cost savings would benefit the users.

10.104. We have, therefore, concluded that, in the absence of substantial savings which can be confidently expected to benefit users, the purposes of the merger are not of substantially greater significance in relation to the public interest than the prejudice to the principle of comparison and cannot be brought about except in a manner that conflicts with that principle.

Other matters concerning the public interest

10.105. We next consider whether it is appropriate, in relation to a merger under sections 29 and 30 of the Water Act, to consider other public interest issues and whether, in doing so, we should take account of section 84 of the 1973 Act. The parties submitted that if for any reason the requirements of section 30(3)(a) were not satisfied on what they considered to be the proper construction of the Water Act, as summarised at paragraph 10.21, there were no further matters of public interest that the MMC were either required or entitled to consider; in particular section 84 of the 1973 Act was not applicable.

10.106. The parties' argument was that the present reference was made under the Water Act and not the 1973 Act. If the Secretary of State had wished to make a reference under the 1973 Act in addition to a reference under the Water Act he could have done so. Section 29(8) of the Water Act could not be taken to have implicitly repealed the relevant provisions of the 1973 Act. This was a mandatory reference, the purpose of which was to consider the merger under sections 29 and 30. The parties argued that, if for any reason section 30(3)(a) was not triggered, there was no particular reason to expose water enterprises to an inquiry into other perceived public interest issues in the absence of any reference under the 1973 Act (paragraph 9.48).

10.107. After taking account of the advice we have received and the arguments that have been put to us, we consider that it is appropriate for us, having first had regard to the desirability of giving effect to the principle set out in section 30(3)(a) so far as it falls in a particular case to be done, to take account also of section 84 of the 1973 Act. In particular we note that section 30 provides expressly for the application of the provisions of the 1973 Act, subject to certain exclusions. These exclusions do not include section 84. We are advised and accept that to regard section 84 as thus applicable would be consistent with the general principles of statutory construction and with an approach adopted elsewhere in the Water Act (see the specific incorporation, in sections 16 and 17 of provisions of the 1973 Act in relation to another type of reference and report) and that its applicability is not excluded by necessary inference. We also note that section 30(3) itself contemplates that regard is to be had to the desirability of achieving purposes other than those set out in section 30(3)(a). However, we are also advised and consider that in a case such as the present where we conclude that the principle in section 30(3)(a) applies, our consideration of the public interest by reference to section 84 should be subject to the principles of section 30(3)(b).

10.108. In view of this we now consider some issues which appear appropriate to the public interest in relation to the proposed merger.

The allocation of cost savings which arise from the merger

10.109. The first question we have considered is whether and, if so, in what manner and to what extent any cost savings which result from increased efficiency or other matters arising as a result of the merger ought to be reflected in reduced water charges, or should be retained by the companies for the benefit of their shareholders. We have explained above that the quantifiable efficiency improvements which the parties consider can be derived from this particular merger would be such that they could make a significant reduction in the level of charges. Benefits have also been claimed in relation to the better use of water resources which should benefit consumers. But there are other benefits from the merger which are of no direct benefit to water consumers, notably the ability to embark on new businesses related to the core businesses on a greater scale than would be possible if the three companies were separate.

10.110. In a fully competitive market, to the extent that mergers result in cost savings or other benefits, market forces would operate so as to allocate these benefits between consumers, in the form of price reductions, and shareholders, in the form of increased profits available for distribution. Yardstick competition may, if the DGWS is able to carry out his duties properly, provide that in the longer term, on the revision of the K factors every ten or possibly five years, any efficiency savings would be reflected in the level of K and hence in users' charges. But in the shorter term, unless K is adjusted in the interim to allow for the effects of a merger, the benefits of improvements in efficiency may not necessarily be reflected in charges. Given the importance of maintaining water charges as near as possible to the levels that might be expected in competitive conditions, it would appear

appropriate that at least some, if not all, of the efficiency savings arising in the water enterprise should pass to users. The DGWS has taken the view that it would be appropriate that all such efficiency gains arising from a merger should pass to users and in the long term this appears to be the correct view. In the shorter term, however, the parties have argued that unless some benefits from mergers between water enterprises are available to shareholders, there may not be the necessary incentive to enter into such mergers and the opportunity to make the efficiency changes that will benefit users may be missed.

10.111. In considering these matters we have also taken into account the circumstances in which the quantified efficiency savings are confidently expected to be achievable by the parties. Further savings may well be possible and in order to encourage efficiency the benefits from these further savings in the short to medium term, between K determinations, will pass to the companies. The benefits which the parties expect to derive from diversification (paragraph 9.34) and the other unquantified benefits of the merger will also accrue to the companies and eventually their shareholders. In these circumstances it seems appropriate, having regard to our conclusion in paragraph 10.99, that if the merger occurs all the quantified benefits which the parties have identified should be applied for the benefit of users. This is consistent with the way in which expected efficiency gains were taken into account by DoE in the K-setting procedures. Any other approach would in our view be adverse to the public interest in ensuring that consumers' charges are maintained at the lowest level that is commensurate with determining that the water undertakers have reasonable returns on their capital.

10.112. One of the other benefits that the parties expect from the proposed merger is the closure of the individual headquarters of Colne and Rickmansworth and the siting of the headquarters functions of the new undertaking at the Lee headquarters site at Hatfield. This would require the building of additional premises at Hatfield but would enable the Colne and much of the Rickmansworth sites to be sold. Under the regulatory procedures, when property disposals were anticipated at the time of the appointment, the estimated proceeds of sale, based on professional valuations, were taken into account when K was set. When the property is eventually sold the difference between the anticipated proceeds and the actual realisation, whether it is a positive or a negative amount, will be shared on a 50:50 basis between the consumers and the undertaking. If, however, the undertaking is able to dispose of properties other than those which were expected to be sold at the time of the appointment, the whole of the proceeds are shared on a 50:50 basis between the consumer and the undertaking. In our view, in order to maintain pressure on management to achieve the maximum saving from the property disposals and avoid unnecessary expenditure on the new building, it would be appropriate to follow the procedures which apply to anticipated disposals and for the whole of the net realisation arising from the disposal of the Colne and Rickmansworth headquarters and the cost of the new building to be made available to the consumers with any difference between the anticipated realisation and the actual figures shared on a 50:50 basis between the consumer and the new undertaking.

10.113. Another factor to be taken into account in considering how the efficiency savings might be allocated is the position of the companies concerned in the merger in relation to their appointments as water undertakers. At present Colne, Lee and Rickmansworth have separate appointments and K factors have been set for them by the Secretary of State for the Environment which, unless the companies voluntarily seek amendment, will not normally be changed for at least five years. Under the terms of the Water Act it would be possible, if the merger took place and the three companies were integrated, for the DGWS to make a new appointment for the Three Valleys company and to rescind the separate appointments for the three existing companies. In the K-setting process for the new appointment, the DGWS could take account of the cost savings. But we understand that this can only occur if the parties concerned agree to the new appointment.

10.114. The DGWS has told us that in his view it would be appropriate for the new appointment to be made as soon as possible; he considered that with the information available from the current K-setting process and arising from our report, a new K could be set in some three months. The parties on the other hand have told us that, while they accept, in the longer term, the need for a new appointment for Three Valleys, they see this as occurring in up to five years' time, possibly at the time of a general review of K. If a new appointment was to be made earlier, the parties foresaw problems perhaps in relation to minority shareholder interests and in the amount of management time that would be involved in the arrangements for the new appointment and a new K.

10.115. In our view when a merger of water enterprises is contemplated that will result in a single management of contiguous water enterprises, a new appointment should, for two reasons, normally follow. First, it is clear that the Water Act envisages that a business of water supply should have a single appointment as a water undertaker; there is no provision for separate appointments for businesses which are contiguous and managed as a single operation. Secondly, it will usually follow that, as in the present case, lower costs and other benefits will follow if businesses with joint aims and assets that are contiguous and jointly controlled are managed with a minimum of intermediate management tiers. In the present case we have been told that it has been understood for many years that benefits would arise from a single business but that it was not found possible to bring this about, partly because of the interest of the individual company Boards and the personalities involved which could not be reconciled. A further five-year period, with the degree of separate management that would be necessary if three appointments were retained, would in our view be likely to reduce the benefits that are obtainable from the merger.

10.116. For the reasons set out above, we have therefore concluded that, unless arrangements can be made for a new appointment of Three Valleys Water Services PLC as a water undertaker with a new K to take effect in the charging year after the merger is approved by the shareholders of Colne, Lee and Rickmansworth, the full benefits of the merger are unlikely to be obtainable. We consider that it is detrimental to the public interest that the arrangements which are in contemplation do not provide for a new appointment to be made for Three Valleys and a new K to be set immediately after the merger takes place.

The effect of the merger on the level of water charges for individual users

10.117. At present the level of water charges in the three companies is somewhat different. Direct comparison of fixed domestic charges is not possible as they depend on rateable values but the metered charges, which are shown below with the domestic charges, reflect broadly the same differences in the level of charges.

TABLE 10.3 1989/90 water charges

	<i>Colne</i>	<i>Lee</i>	<i>Rickmansworth</i>
<i>Metered</i>			
Per cubic metre (pence)	26.5	31.0	28.3
Standing charge (12 mm domestic connection) (£)	33	44	26
<i>Non-metered domestic</i>			
Standing charge (£)	13.50	17.00	14.00
Rate in the £ (pence)	12.60	15.25	11.50

Source: The companies.

10.118. If the three companies remain separate the levels of these water charges would be changed by the Ks which have been set for the individual companies. On the basis of the information available to us this suggests that, without the merger, present differences in charging levels may narrow but that differences are likely to remain.

10.119. From the evidence we have been given it appears that it has been practice in the past, when mergers between SWCs have taken place, for the charges to have been rationalised in a way which, after a period of years, has meant that a common charge has been set for the new SWC. This has meant that some users with previously relatively low charges have seen greater than average increases while others, with higher charges, have seen lower increases. The position in the future is complicated by the fact that fixed water charges will not be based on the rateable values of domestic properties after the year 2000, so that a new charging structure will have to be devised, based possibly on metered users or on the level of occupancy of a property.

10.120. The rationalisations which have taken place in the past have been subject to a degree of Government direction, or at least approval, of the mergers concerned and where SWCs have been subject to controls on the level of dividends. Now that future control is to be based on yardstick competition, and in the circumstances where users have no alternative sources of supply, it could be argued that it would, for example, be inappropriate for a user in Colne to pay significantly more for his water because of a merger intended in part to improve the long-term profitability of the merged group.

10.121. The DGWS has explained that one of the general principles which he was required to follow in the setting of charges was to ensure that there was no undue discrimination between users. In judging whether there was any discrimination, his primary consideration would be the allocation of costs properly attributable to the supply of water to the customers. 'Undue' discrimination obviously introduced an element of judgment and it might influence him to have regard to the practicalities (and costs) of requiring charging schemes which were not uniform in an undertaker's area.

10.122. The DGWS told us that in the case of the Three Valleys companies there might well be differences in the cost of supply and treatment which would justify differences in charges. However, if the merger were to lead to an integration of the distribution network and to a convergence of costs this might be a justification for a convergence of charges over time. But if there remained significant differences in costs, the burden of proof would be on the company seeking to equalise charges. The parties (see paragraphs 9.92 to 9.94) took the view that the cost structure of the three companies was similar and that the present difference in charges resulted from different finance and debt structures and recent increases in charges in anticipation of high future investment levels.

10.123. While there is a public interest in ensuring that the merger does not lead to unfair discrimination between customers of the existing companies, we do not think it would be appropriate for us, in view of the evidence of the DGWS and the complications which arise from the certainty of changes in charging structures over the next ten years, to lay down any detailed guidance. We consider, however, that in the circumstances of a non-competitive market, it would be detrimental to the public interest if classes of consumers in the presently separate companies were required to pay more by way of water charges than would have been the case if the merger had not taken place.

The effect of the merger on employment

10.124. The parties have told us that they expect the merger to lead to a reduction of [*] posts in the current establishment of the three companies a reduction of some [*] per cent. Although all levels of staff are involved, the majority of reductions will be among engineering and clerical employees, especially those in the lower grades. The companies claim that the effects of a [*] per cent reduction in employment will not be as severe as might otherwise have been the case. They have already put a 'freeze' on recruitment, and this, coupled with high labour turnover, has resulted in under-staffing in some areas leading to the engagement of temporary staff. Some of these vacancies may be filled by employees displaced by the proposed reductions in the other areas.

* Figures omitted. See note on page iv.

10.125. The two unions which represent employees in the three companies expressed concern about the future of arrangements in relation to terms and conditions of employment, and in particular redundancy, pensions and negotiating procedures.

10.126. The companies responded by giving written assurances (Appendix 9.2) to the unions that:

- (a) there will be no compulsory redundancies arising directly from these merger proposals;
- (b) if as a result of the merger it is necessary to agree early retirements with individual employees, terms will be made available in accordance with existing arrangements;
- (c) existing pension rights and benefits for existing employees will not be affected adversely by the merger; and
- (d) they will recognise appropriate trades unions.

10.127. In these circumstances, and having regard to the benefits to water users of the reduced costs and greater efficiency that will arise from the proposed merger, we do not consider that the anticipated loss of employment opportunities in a high employment area may be expected to be adverse to the public interest.

The terms offered to shareholders

10.128. We have been given evidence by the Panel on Take-overs and Mergers that, because a reference to the MMC was obligatory under the terms of sections 29 and 30, it was not considered appropriate for a detailed offer to the shareholders to be necessary at the time the merger proposal was announced.

10.129. Sufficient detail was, however, included in the published announcement to indicate that the proposed merger was intended to be by way of share exchange, with no mention of a cash alternative. Taking account of the relative valuations of the individual companies the merger would, we were told, result in GU obtaining a majority of the shares of the Three Valleys company, and thus control through that company of Colne and Rickmansworth, in addition to Lee which it already controls.

10.130. If the proposed merger were allowed to go ahead, it would be for the individual Boards of Three Valleys, Colne, Lee and Rickmansworth, as separately advised, to decide on the appropriate terms to be offered and, if thought fit, recommend them to their shareholders. Ultimately the shareholders will decide whether to give their approval to the merger.

10.131. It is not the duty of the MMC to comment on the provisional offer; the absence of comment should not be taken as necessarily implying that we approve or disapprove of the terms that were outlined at the time of the announcement of the offer.

Conclusions

Section 30 of the Water Act

10.132. The MMC have concluded, in relation to section 30(3)(a), that the principle set out applies as regards the proposed merger so as to involve such a reduction in the number of water enterprises under independent control as may be expected to prejudice the DGWS's ability to carry out his functions under the Water Act to make comparisons between different such water enterprises (paragraph 10.77).

10.133. The MMC have also concluded, in relation to section 30(3)(b)(i), that certain purposes of the merger, including cost and financial savings, cannot be fully achieved without the merger and therefore, without prejudice to the DGWS's ability to make comparisons and consequently, cannot be achieved in a manner which does not conflict with the principle expressed in section 30(3)(a) (paragraph 10.90).

10.134. The MMC have, however, noted that the continued provision of certain financial information to the DGWS after the merger in relation to the areas presently supplied by Colne, Lee and Rickmansworth may be expected to reduce the prejudice.

10.135. The MMC have also concluded, in relation to section 30(3)(b)(ii), that, in the absence of substantial savings which can be confidently expected to benefit users, the purposes of the merger are not of substantially greater significance in relation to the public interest than the prejudice to the principle of comparison and cannot be brought about except in a manner that conflicts with that principle (paragraph 10.104).

Further public interest issues

10.136. The MMC have concluded that it is detrimental to the public interest that the arrangements which are in contemplation do not provide for a new appointment to be made for Three Valleys and a new K set as soon as possible after the merger takes place (paragraph 10.116).

10.137. The MMC have also concluded that, in the circumstances of a non-competitive market, it would be detrimental to the public interest if classes of consumers in the presently separate companies were required to pay more by way of water charges than would have been the case if the merger had not taken place (paragraph 10.123).

10.138. Having regard to the conclusions which we have set out above in particular, in paragraphs 10.77, 10.90, 10.104, 10.116 and 10.123 we consider that section 30(3)(b) does not apply so as to negate the desirability of giving effect to the principle set out in section 30(3)(a). This appears to us to be so whether the matter is looked at specifically in the terms of section 30(3)(b), or (subject to that provision) by reference also to section 84 of the 1973 Act. We therefore conclude that the creation of the merger situation which we have identified may be expected to operate against the public interest.

10.139. It further appears to us that the provisions of section 72(2) of the 1973 Act are applicable and that, in view of this finding, we are required to specify the particular effects adverse to the public interest which the creation of the situation may be expected to have. We consider these to be as follows:

- (a) that the proposed merger involves such a reduction in the number of water enterprises which are under independent control as may be expected to prejudice the DGWS's ability to carry out his functions by virtue of the Water Act to make comparisons between different such water enterprises (paragraph 10.77);
- (b) that the arrangements contemplated for the merger do not provide that, to balance the prejudice in (a) above, consumers of water shall receive all the benefit of quantifiable cost savings arising from the merger (paragraph 10.103);
- (c) that the arrangements contemplated for the merger do not provide for a new appointment for Three Valleys Water Services PLC and for the setting of a K immediately after the merger takes place (paragraph 10.116); and
- (d) that the arrangements contemplated for the merger do not provide that classes of water consumers in the individual companies should not be called upon to pay more than would have been the case if the merger had not taken place (paragraph 10.123).

Recommendations

10.140. We are further required by section 72(2) of the 1973 Act, where we have found that a merger situation operates or may be expected to operate against the public interest, to consider what action (if any) should be taken for the purpose of remedying or preventing the adverse effects which we have identified and, if we see fit, include suitable recommendations in our report.

10.141. In the course of our investigation we have discussed with the DGWS and the parties the possibility that we might put forward certain remedies to detriments that have been identified. Their views on the remedies we put forward are included in Chapters 6 and 9. While the DGWS was broadly prepared to accept the remedies, the parties' comments were subject to reservations of principle in relation to their interpretation of sections 29 and 30. They also reaffirmed their view that it would not be practical or desirable for an early appointment to be made in relation to Three Valleys. They told us that while they expected to be able to ask the DGWS to make such an appointment within a five-year period after the merger, no definite timing could be given because of the uncertainty of shareholders' response to the merger proposals. They were also concerned about their contingent ability to recover Advance Corporation Tax which has been accumulated by Colne, Lee and Rickmansworth and suggested that there were impediments in the Water Act to any corporate structure which would avoid this problem while at the same time allowing a single appointment.

10.142. The DGWS and the parties were not in agreement as to the impact of these problems, which raise complex matters concerning taxation law and the interpretation and future operation of the Water Act. For the reasons we have set out previously, we consider that, in mergers of contiguous water undertakings where joint management is proposed, a new appointment and new K should be made as soon as possible after the merger has taken place. It is for those proposing the merger to decide, when the response to the merger proposals is known, whether a new appointment is possible and thus whether to proceed with the merger.

10.143. The parties put forward a proposal that they would be prepared to undertake to reduce water charges for the individual three companies in the period of five years after the merger by amounts equivalent to 50 per cent of the operational cost savings and proceeds of property sales less the cost of new buildings and certain one-off costs. If this proposal were to be accepted, it would be for the DGWS to take account of future savings in any interim review of K for the existing appointees or, if by that time a new appointment had been requested by the companies, in respect of Three Valleys.

10.144. While the parties' proposal would bring a reduction in water charges in the first five years which might be greater than that resulting from a new appointment and a new K, it would not provide for the certainty of an early new appointment for Three Valleys or that all the savings which have been identified would be passed to consumers over a longer period. We are unable therefore to accept that this proposal remedies the adverse effects we have identified.

10.145. We consider, however, that the adverse effects we have identified are capable of being remedied by undertakings and that if the parties are prepared to take the necessary actions that will enable them to make the undertakings we are recommending, there would be no need to prohibit the merger.

10.146. We therefore recommend that, to remove the detriments we have identified under section 30(3)(a) of the Water Act and section 84 of the 1973 Act, the parties should be required to give the following undertakings to the Director General of Fair Trading (DGFT):

- (a) The parties will undertake that they will, within three months of the publication of this report, request the DGWS to make, if the merger takes place, a new appointment in relation to Three Valleys Water Services PLC as a water undertaker in replacement of the appointments presently held by the Colne, Lee and Rickmansworth water companies.
- (b) The parties will undertake that they will fully co-operate with the DGWS in the setting of a new K for the new water enterprise, with a view to the new K taking effect from the beginning of the charging year immediately after that in which the merger becomes unconditional. In particular the parties will undertake to provide the DGWS with all necessary access to information that he may require to set the new K.
- (c) The parties will undertake to accept that, in the determination of a new K by the DGWS, the changes in the level and timing of costs arising from the merger (set out in Annex 2 of Appendix 4.1) and the financial position of the merged company may be taken into account by the DGWS on the basis that, during the period in which the savings are achieved, all the savings should wholly be applied to users in line with the established K-setting process. Property sales should be taken into account in accordance with the provisions in the licence relating to the disposal of notified land. This will have the effect of ensuring that, with the safeguards mentioned in paragraph 10.112, all the net benefits from the property transactions pass to consumers.
- (d) The parties will undertake that in the setting of water charges for users, the new water enterprise, Three Valleys, will agree that in each of the first ten years after the merger has taken place to determine the charges in such a way as to ensure, as far as is reasonable, that no class of water user should be called upon to pay more than would have been the case if the merger had not taken place. This undertaking should include a provision that, before any new charges for the Three Valleys area are announced, the parties will put them to the DGWS for his agreement to the effect that this undertaking has been met.
- (e) The parties will undertake to maintain the areas currently served by Colne, Lee and Rickmansworth as separate profit centres and provide the DGWS on request with such information that he may require in relation to these profit centres for the purpose of carrying out his duties of comparison under the Water Act. This undertaking is to be reviewed by the DGFT at the time of the next periodic review.
- (f) The parties will undertake to provide the DGFT and the DGWS with such information as they may require to negotiate the undertakings and keep them under review.

H H HUNT (Chairman)

A G ARMSTRONG

R O DAVIES

J D KEIR

D P THOMSON

C A UNWIN

S N BURBRIDGE (Secretary)

12 February 1990