9 The views of the main parties

9.1. We received evidence and representations from Colne, Lee and Rickmansworth, as well as from GU and CGE. We held a hearing with each company individually, as well as a joint hearing with all the companies. In the course of their representations, the parties presented legal arguments, which we considered at a hearing. During the course of our inquiry, we sought the parties' response to a number of possible public interest issues, which were considered at a subsequent hearing. Certain draft undertakings were put to the parties for their comments during the latter stages of our inquiry. We also visited some of the facilities of Colne, Lee and Rickmansworth, and visited the Iver Treatment Works.

9.2. The parties told us that Colne, Lee and Rickmansworth formed a natural operating unit encompassing almost the entire catchment areas of the rivers Colne and Lee. All three companies had recognised for some time that they would need to supplement their water resources due to projected growth in demand. This recognition had led to co-operation between the companies since the mid-1960s, and to the formation in 1970 of the Three Valleys Water Committee which was established to construct and operate the water treatment works at Iver as a joint resource for the three companies. The companies told us that the existing close working relations between the companies were reflected in joint operating arrangements and in a number of joint directorships. Colne and Rickmansworth had a common Managing Director.

9.3. All the parties emphasised to us that the initiative for the merger came from the three companies themselves, not from CGE. They did, however, enjoy the full support of CGE in the merger proposal, and CGE specifically endorsed the representations made to us by the companies.

9.4. The companies told us that if they continued to operate independently under the new regulatory regime, the scope for future joint initiatives between them would be limited and the continuation of existing links would be difficult to ensure. Existing co-operation between the companies was a partnership of equals, dependent on the continuing goodwill of all the participants. The companies told us that this had not in the past inhibited the development of the Iver Works, but this successful co-operation had been made easier by the then existing financial framework for SWCs, based on dividend control as opposed to price control. This had meant that companies had not been constrained to maximise short-term profitability by limiting their contributions to the Iver Works. Had they been concerned with short-term profitability, the companies told us that this would have led to tougher negotiations and less effective co-operation.

9.5. The parties went on to observe that, once SWCs converted to plcs, shareholders would aspire to higher dividends, and thus profits, while at the same time the directors would become subject to the corpus of directors' duties under the Companies Acts. Apart from having to negotiate contracts on a fully arm's length basis, they would also be obliged to ensure that their companies were not excessively dependent on the continuing goodwill of counter-parties whose management or control might change.

9.6. Taken together with the increased cost of complying with the new statutory requirements, these factorsthe increased profit aspirations of shareholders and the restrictions on directors operating under the Companies Actswould, the parties told us, make it increasingly difficult to rely exclusively

on co-operation and goodwill. If the merger did not proceed, the companies considered that not only would further development be made more difficult, but that even the maintenance of existing levels of co-operation between them could not be assured.

9.7. Consequently, the parties told us they considered that the three companies needed to adopt a common strategy in the development and management of resources, and work together to ensure the efficient undertaking of capital investment programmes. This was necessary if they were to make the most efficient use of their water resources and their supply and distribution systems, while meeting the exacting standards of water quality and services set by the Water Act.

9.8. The companies told us that, in their view, the only practical means of securing this co-operation in the new environment was through common ownership and management. Consequently, the merger proposals had been initiated by the companies, with the full support of CGE in response to the fundamental changes taking place in the water industry. The parties explained that they regarded CGE's involvement as an important ingredient in their proposal, particularly in view of the importance which CGE placed on local accountability to customers.

Benefits of the merger

9.9. The parties told us that they believed substantial benefits would flow from the merger to the benefit of the companies' customers. These included:

(a) greater self-sufficiency and flexibility in the use of water resources;

(b) more efficient and effective use of an integrated distribution network;

(c) security of supply, including water quality;

(d) opportunities for cost savings through the deferral of capital expenditure, and the rationalisation of support services;

(e) a business with the ability to attract and retain high calibre staff;

(f) increased financial strength both through an enhanced ability to attract funds from the capital markets and through the support of a major shareholder with significant assets and expertise world-wide; and

(g) 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.

9.10. The parties told us they considered that the merger would also provide a positive example of the promotion of efficiency and competition in the water industry. The merger would create a water supply undertaking equivalent, in supply terms, to the smaller WSPLCs and which would have ready access to the support, technical expertise and skill of GCE. This, the companies told us, would assist the DGWS in his task of promoting economy and efficiency within the water industry. The parties believed that the merger would not prejudice, and might even enhance, the ability of the DGWS to make comparisons between different water enterprises in fulfilment of his functions under the Water Act.

Commercial rationale and benefits to consumers

9.11. The companies provided evidence which set out the commercial rationale for the merger, and the benefits which they considered it would bring to water consumers in the Three Valleys area.

9.12. The parties told us that if the companies merged, they would be able to integrate their supply and treatment networks. This would mean that some existing sources would be able to be better used than at present: advantage could be taken of the different characteristics of each water

source to give a combined yield greater than might be achieved by the independent operation of the same sources.

9.13. At the same time, the parties told us, they would be able to make more efficient use of their existing distribution systems if these were integrated, and that the linking of water sources in a larger network would improve the overall security of water supply in the region, by enabling water to be easily diverted to meet water quality or pollution problems, or to bypass major pipe bursts. The companies also told us that an integrated water system would enable Three Valleys to achieve greater flexibility in the timing and priority of major capital projects. Operating independently, the companies would be obliged to undertake separate capital projects in the early years of the new regulatory regime which would be both less efficient and less economic than joint projects.

9.14. The parties also provided us with information on the likely financial and operational savings which would result from the merger, as a result of rationalisation in engineering operations, scientific services, finance and secretarial, business planning and property, information technology, and regulatory compliance. This is set out fully in Chapter 4 and Appendix 4.1. The parties told us that the merger would also improve their ability to compete in the local market for staff. The companies' area was characterised by intense competition for skilled and unskilled staff. Currently, there were difficulties recruiting and retaining staff of the necessary calibre; this was being exacerbated by the abolition of national pay scales in the industry, combined with competition for staff from Thames Water Plc and Anglian Water Plc. Furthermore, the parties commented that it was well recognised that small operating units had great difficulty recruiting and retaining able employees, as they were often unable to match the work experience, career prospects or training opportunities of larger organisations. The merger would produce a larger unit with a significantly improved ability to recruit staff with the necessary skills, and would enable those skills to be more productively deployed in a larger unit.

9.15. The parties told us that the merger would enhance the ability of the companies to compete effectively for funds in debt and equity markets. The merged concern would present a more attractive investment opportunity because of its improved levels of efficiency, greater market capitalisation, and the presence of CGE as a shareholder with a significant capital commitment as well as significant technical expertise. The merged company would, we were told, be more able to achieve a favourable stock market rating as a result of its enhanced ability to diversify into areas of business outside the regulation of the Water Act. At the same time, the company was likely to require a lower overall level of financing, and be able to obtain debt finance at more favourable rates than would be the case if each of the companies continued to operate separately.

The public interest

9.16. The parties provided evidence on the public interest, including their interpretation of the statutory framework provided by the Water Act and the role of the DGWS, and its application to the Three Valleys merger proposals.

9.17. The companies submitted that the merger provisions of the Water Act, set out in sections 29 and 30, maintained the principle established in the 1973 Act that, in conducting an inquiry, the MMC were not faced with a presumption that a merger was contrary to the public interest. The issue was whether the merger operated or may be expected to operate against the public interest.

No prejudice to the functions of the DGWS

9.18. The parties explained that they saw the purpose of the principle set out in section 30(3)(a) of the Water Act as to ensure that the DGWS, in carrying out his functions under the Act, remained able to derive adequate data from water enterprises to compare their efficiency. The parties submitted that the merger would not prejudice, and should indeed enhance, the ability of the DGWS to make meaningful comparisons between the water enterprises.

9.19. The companies supported this view by explaining that:

(a) if the merger did not proceed, the companies would not provide three statistically independent comparators;

(b) the merger might be expected to enhance the quality of the resulting comparator as statistically independent and superior to the existing comparators if the merger did not take place; and

(c) should comparative information available to the DGWS having regard to the number and quality of comparators be deemed to have changed as a result of this merger, there was no presumption that such change would prejudice the ability of the DGWS to perform his functions effectively.

Existing companies not statistically independent comparators

9.20. The parties submitted that, by virtue of the joint asset ownership and management arrangements for the Iver Works, the three companies did not now provide three statistically independent comparators and the extent to which they did provide a degree of statistically independent information would decrease over time even if they did not merge: water taken from Iver by Rickmansworth in 1988/89 (52 megalitres per day) accounted for some 26 per cent of its total demand and water taken by Colne (48 megalitres per day) accounted for some 23 per cent of its total demand. Forecasts of demand showed increases over the next ten years of a further 28 megalitres per day for Rickmansworth and 23 megalitres per day for Colne increasing their reliance on Iver to some 35 per cent and 33 per cent respectively. Lee gave notice in April 1989 that it intended to commence taking water from Iver in 1991. In this light, the three companies would be obliged to invest jointly in expansion of the Iver Works in order to satisfy these demands with consequent increases in capital and operating costs. The existing and increasing future significance of Iver to the three companies and the consequent cost-sharing arrangements results in the efficiency of the companies being increasingly interdependent both now and in the future.

9.21. Accordingly, because of the extent of shared costs the three companies do not provide at present three fully statistically independent comparators. In view of the increasing level of costs due to the extension of Iver, the data which the DGWS would receive from the companies individually, if they did not merge, would become increasingly correlated and thereby statistically less useful for comparative purposes.

An enhanced comparator

9.22. In contrast to the present situation the parties claimed that the merger would create a more efficient unit which would be of more value to the DGWS as an indicator of the levels of efficiency achievable and avoid the distorting effects of the existing joint asset ownership and management arrangements. The merger would create a group whose size and geographical spread would make it comparable in terms of water supply with the smaller WSPLCs. The new group would supply 706 megalitres per day compared with the equivalent figures of 730 and 662 megalitres for Southern Water plc and Northumbrian Water PLC; it would rank as the eighth largest water undertaker and would thus provide a further water undertaker in the middle range. This should be a useful comparator for the larger water undertakers, in particular those which have a similar profile of water sources and share the topographical and demographic diversity of the Three Valleys area.

No presumption of prejudice

9.23. The companies emphasised that they saw the ability to make comparisons between water enterprises as not an end in itself but related 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 Water Act, in particular to promote economy and efficiency on the part of water undertakers. In so far as the SWCs are concerned, the structure of the water supply industry in England and Wales at the date of the passing of the Water Act reflected an evolutionary process of growth and acquisition to improve efficiency in utilisation of resources and infrastructure rather than the result of any co-ordinated and systematic planning. The parties submitted that it could not have been intended that section 30(3)(a) of the Water Act should be interpreted so as to ossify the existing number of companies, however costly or inefficient, purely so that comparative data would be available to the DGWS in 50 years' time in the same form as it was available today. Instead, the parties submitted, the intention must be that the DGWS should, in order to carry out his functions, have access to adequate comparative data of a kind which would help him to promote efficiency and economy.

9.24. The parties considered that if the DGWS (or indeed any other interested party) considered that the merger would prejudice his ability to carry out his functions under the Water Act by making comparisons between water enterprises, then it was for the DGWS to demonstrate the ways in which prejudice would actually result. It was not sufficient merely to demonstrate a change or reduction in the amount of data which would be available to the DGWS. If adequate information remained available in that there were a sufficient number of statistically independent comparators for him to adequately perform his functions, no prejudice could arise.

9.25. The parties further submitted that the regulatory mechanisms in the Water Act had been designed, in large part, to serve as a substitute for the normal action of competitive forces which could be expected, over time, to ensure that output was produced at least cost, but with reasonable financial returns to the shareholder or on the capital employed. The structure of the water industry, which was perhaps the most natural monopoly of all public utilities, had evolved as a result of various influences other than competition between suppliers. The parties demonstrated that both Government policy and legislation had encouraged or brought about the grouping of water enterprises into larger and more viable organisations; a process that went back to the immediate post-war years.

9.26. The parties submitted that allowing structural changes in the industry was one of the few options available to a regulator to enhance efficiency in the industry. This reflected the fact that in the water industry the structure was unlikely to be influenced by competition and there were no opportunities to foster new entrants, as there were in the telecommunications and gas industries. The parties suggested therefore that neither the independent control principle nor the statutory obligations of the DGWS should be interpreted in such a way as to give rise to presumptions against, or obstacles to, the continuing evolution and development of the water industry.

9.27. In addition, the companies believed that the merger would bring benefits to the public at large by enhancing the quality of comparative information available to the DGWS in performing his duties under the Water Act and would provide increased competitive opportunities outside the immediately regulated business of water supply. The parties told us that in their view the merger would promote competition in the water industry by creating a dynamic grouping with innovative flair and access to international experience which could provide an example to other water undertakers as they responded to the requirements of the market and the new regulatory regime.

9.28. The parties explained that Three Valleys would have full support from, and access to, the technical resources of CGE, and CGE as a shareholder would have a direct interest in promoting efficiency. They expected to gain valuable insights from contact with CGE subsidiaries and affiliates in France and other parts of the world and to benefit from the opportunity to pool ideas. The companies believed that all these factors would make the group a useful comparator, in particular for the larger water undertakers. In this way the merger would assist the DGWS in his task of promoting economy and efficiency in the water industry and contribute to the Government's desire to promote competition. In addition, the parties told us that they considered the merged enterprise would be more efficiently run than the existing companies, and thus provide a qualitatively better comparator in efficiency termsit would be closer to the frontier of possible efficiency than otherwise.

Benefits to customers

9.29. The parties explained that they believed that the system of economic regulation established under the Water Act would lead to the substantial benefits inherent in the merger ultimately being passed on to the customers in the form of lower increases in charges than would otherwise be the case.

9.30. The conjunctive use of the various sources and improved water supply and distribution systems that were intended to be brought into effect due to the merger would enable the companies to achieve a more efficient and cost-effective supply of water in the Three Valleys area. The standards of water quality demanded by United Kingdom legislation were imposing increasing burdens, both technical and financial, on water undertakers. Against this background, the parties submitted, the ability of the companies to amalgamate their existing laboratories and to combine their financial resources to invest in new equipment would directly benefit their customers.

9.31. The level of investment required of companies operating in the water industry was substantial. This would, the parties considered, place a particular burden on SWCs which have hitherto been prevented over many years, by restrictions on the accumulation of reserves, from making provision for any significant level of internal funding of capital expenditure. The merger, the parties submitted, would not only make the companies more attractive to investors in the longer term, but would also reduce the overall quantum of capital investment which would be required of the companies compared with the position if they were not to merge. These benefits would ultimately flow through to customers under the regulatory regime.

9.32. At the same time, the managements of the companies were committed to ensuring that the quality of local service which customers received at present from the companies should continue and improve following the merger. They believed that the merger would enhance their ability to respond swiftly and efficiently to customer needs by centralising certain of the administrative functions and achieving other efficiencies of scale. After a merger, they would be able to free resources, both human and financial, whilst improving the quality of service at the local level. The companies explained that they were confident that they would continue to be greatly encouraged and supported in this by CGE. They were aware that the CGE group regarded the maintenance of high standards as a vital element in the provision of local services and it had made this a priority while at the same time achieving greater efficiency.

Benefits to the public at large

9.33. The parties submitted that since all water undertakers, including Colne, Lee and Rickmansworth, have a natural monoply within their individual supply areas, the benefits identified above as being likely to flow through to customers would inevitably be of direct benefit only to customers in the relevant supply areas. Water undertakers would not be able to compete for customers by, for example, offering a more efficient or cheaper service (except in the very limited context of inset appointments provided for by section 12(2) of the Water Act). However, it was explained that this did not mean that water undertakers would not be subject to the demands which competition would impose in the absence of a natural monopoly or that there would not be effective competition, in certain important respects, between water undertakers.

9.34. The companies believed that the merger would facilitate competition in a wider sense. The new group would compete for funds in the capital market with other water enterprises. In the longer term the companies intended to use the opportunity provided by the new statutory regime, which frees SWCs to engage in other activities, by developing activities relating to water supply in order to use their assets more profitably. The group would be of sufficient size, in terms of population, area and turnover, to diversify in competition with the WAs, a number of which clearly intend to set out on this road. The parties therefore submitted that the companies were confident that the new group would not only be better placed to provide an improved and more economical service to its

customers, but would also provide a challenging example of what can be achieved by water enterprises within the new regulatory environment.

Legal arguments

9.35. In the course of their evidence the parties advanced a number of important legal arguments concerning the interpretation of the Water Act, and its application to the position of the Three Valleys companies. These arguments were developed by the parties at a hearing devoted to this purpose.

9.36. The principal argument concerned the interpretation of section 30(3) of the Water Act.[1] The parties told us that the principle set out in section 30(3)(a) of the Water Act required the MMC to first assess whether the merger would result in a reduction in the number of water enterprises under independent control. For this purpose section 30(6) of the Water Act provided that:

> … the reference to the number of water enterprises under independent control is a reference to the number of water enterprises there would be if two or more water enterprises counted as one enterprise wherever they would be treated for the purposes of Part V of the Fair Trading Act 1973 as having ceased to be distinct enterprises.

9.37. Section 65 of the 1973 Act set out the circumstances in which enterprises were to be treated as having ceased to be distinct for the purposes of Part V of that Act. It provided three stages at which two or more enterprises were to be regarded as having ceased to be distinct, by coming under common control:

(a) when one acquires the ability materially to influence the policy of the other;

(b) when one acquires the ability to control the policy of the other (so-called de facto control); and

(c) when one acquires a controlling interest in the other.

9.38. The parties submitted that, in relation to the independent control principle, section 30(6) of the Water Act envisaged that a water enterprise would cease to be under independent control when it first ceased to be distinct from any other water enterprise. The companies went on to submit that, because the water enterprises carried on by Colne, Lee and Rickmansworth had already ceased to be distinct from a number of other water enterprises, the proposed merger would not lead to any reduction in the number of water enterprises under independent control. The parties told us that the benefits of the merger could therefore be considered without conflicting with the independent control principle.

9.39. Specifically, the parties told us that Colne and Lee had ceased to be distinct from the other water enterprises controlled, or which might be deemed to be controlled, by CGE in the United Kingdom: Tendring Hundred, Folkestone and District, North Surrey, Bristol, South Staffordshire and Mid Kent.

9.40. Rickmansworth had, the parties told us, ceased to be distinct from the water enterprises controlled by SAUR.

9.41. With regard to Lee, CGE held 99 per cent of the issued voting capital and thus held a controlling interest. With regard to Colne and Rickmansworth, the parties told us that CGE and SAUR respectively by virtue of their shareholdings were in a position materially to influence the policies of the two companies. The parties commented that all that was necessary for the purposes of Part V of the 1973 Actand thus the Water Actwas to show that CGE and SAUR were able materially to influence the policy of Colne and Rickmansworth respectively, and that it was not necessary to establish that either had actually exercised any influence, or intended to do so. The parties argued

[1] Appendix 1.2 sets out sections 29 and 30 of the Water Act.

that the shareholdings of CGE and SAUR conferred a reasonable prospect of their being able to obtain Board representation if they wished, either through the consent of the relevant Board, or by vote at a general meeting. Even without such representation, the parties told us that CGE and SAUR could influence the policy of Colne and Rickmansworth respectively through exercising their voting power at a general meeting, or indicating to the Board in advance how they would do so. In relation to Colne, the parties told us that it was immaterial that SAUR owned 25.2 per cent. The fact that SAUR might have the ability to exercise material influence could not prevent CGE also having material influence.

9.42. We put to the parties the claim made by SAUR that it had sought and failed to have a member appointed to the Rickmansworth Board. We were told that SAUR had been invited to have someone attend meetings, with a view to that person's eventually being invited to join the Board. The Board of Rickmansworth was uncomfortable with this arrangement and decided not to issue such an invitation, so that discussions on the company's future could be completed without a SAUR representative.

9.43. Furthermore, the parties told us that there were factors specific to the statutory framework in which SWCs operated which meant that holding more than 25 per cent of the voting capital of an SWC gave the holder the opportunity materially to influence the policy of the SWC. The Water Act provided that, by a resolution requiring a 75 per cent majority, an SWC may re-register under the Companies Act 1985, and thereby convert to plc status, and might similarly disapply existing limits on borrowing, share issuing powers, and the payment of dividends. The parties told us that compliance with the requirements of the Water Act placed a substantial financial burden on SWCs which would in practice be met by new fund-raising exercises dependent on the passing of such resolutions; a shareholder able to prevent the passing of the necessary resolutions would, in the parties' view, clearly be able to exert a material influence on the company's policy.

9.44. The parties told us that they considered that, although Rickmansworth had ceased to be distinct from SAUR, and would as a result of the proposed merger move to being under the indirect control of CGE, this would not lead to a further reduction in the number of water enterprises under independent control. Similarly, CGE's present ability materially to influence the policy of Colne meant that the acquisition by CGE of legal control over Colne would not lead to such a reduction.

Other legal arguments

9.45. The parties raised with us several other legal issues. They told us that, while the MMC were required to investigate and report on whether Colne and Rickmansworth would cease to be distinct from water enterprises carried on under the control of GU (and that this would include Lee), the question also arose as to whether the MMC were under a duty to establish whether additional possible merger situations arose as between Colne and Rickmansworth on the one hand, and, on the other, between each of a number of other water enterprises in which GU had shareholding interests. It was clear that GU had controlling interests in Tendring Hundred, Folkestone and District and North Surrey water companies, but each of these had gross assets below £30 million. Under section 29(3)(b) of the Water Act no take-over of a water enterprise with assets below £30 million may be referred; similarly section 29(3)(c) provides that no reference may be made if the person making the take-over owns water enterprises each of which has gross assets below £30 million. Consequently it was, the parties told us, doubtful if the three enterprises where GU had a controlling interest (other than Lee) could be included in any merger situation.

9.46. The parties went on to argue that, with regard to companies where GU had a minority holdingSouth Staffordshire, Mid Kent and Bristolthe question arose as to whether the MMC were required to determine whether each was under the control of GU (in the sense that GU was able to control or materially to influence the policy of each company), with the further consequence that, if the ability materially to influence policy was established, a series of merger situations would arise between the companies concerned and both Colne and Rickmansworth. The parties argued that this outcome need not be the case: it was, they told us, doubtful that the MMC needed to determine whether or not a merger situation existed in respect of these other water enterprises. There was no

doubt that a merger situation qualifying for investigation existed in respect of Colne, Lee and Rickmansworth, which conveyed jurisdiction to consider the public interest. The parties suggested that within the statutory framework the MMC had discretion as to what they could and sensibly should investigate. They might therefore decide not to devote resources to deciding the technicalities of other possible merger situations if this was unnecessary to establish jurisdiction or conduct a full inquiry.

9.47. The parties raised a further legal question concerning the meaning of the words `... so as to prejudice the Director's[1] ability ... to make comparisons between different such water enterprises' in section 30(3)(a) of the Water Act. The parties argued that, in a case where a reduction in the number of independent comparators did occur, the natural meaning of these words was that the MMC must be satisfied that such a reduction would prejudice the DGWS's ability significantly, and in a clear and obvious way.

9.48. The parties' final legal argument concerned the question of what scope there might be for the MMC to consider the public interest, in circumstances where no reduction in the number of enterprises under independent control had occurred. The parties argued that if the requirements of section 30(3)(a) were not satisfiedie if there was no reduction in the number of independent enterprisesthen the true construction of the Water Act was that there were no further matters of public interest open to be considered. The parties argued that the reference under the Water Act was a mandatory one made to consider section 30. If section 30 was not triggered, then there was, we were told, no reason to expose water enterprises to a mandatory inquiry into other perceived public interest issues. The parties told us that this construction of the Water Act was supported by the structure of section 30: there was no reference in section 30(3) to section 84 of the 1973 Act (which provided for inquiries to look generally into public interest matters); indeed section 30(3) of the Water Act was, the parties argued, a complete code of the matters to be reported on under a Water Act reference. The parties also told us that they considered that even if a general inquiry into the public interest could be carried out, there was no basis for the MMC considering comparative competition other than through section 30(3)(a) of the Water Act. This reflected the fact that, in the parties' submission, it was the intention of the Act that the comparison which the DGWS was to make should be between enterprises which had not ceased to be distinct.

Public interest issues

9.49. In the course of our inquiry, we put a number of possible public interest issues to the parties, and received written representations in response, which were explored further at a hearing.

9.50. We asked the parties to comment further on the possible effects of the merger on the ability of the DGWS to carry out his duties under the Water Act:

(a) in relation to section 30(3)(a) of the Act;

(b) in relation to the public interest in providing the DGWS with a suitable basis for comparison to enable him to carry out his duties under the Act; and

(c) in relation to his duties under section 7 of the Water Act.

9.51. To facilitate the parties' response, we provided them with a summary of certain aspects of the DGWS's evidence, particularly where it included novel or complex arguments concerning the implementation of his duties under the Water Act.

[1]ie the DGWS's.

9.52. The parties told us that it was their contention that in the context of a merger of water enterprises the DGWS's ability to perform his statutory functions was protected exclusively by the operation of section 30(3) of the Water Act. The approach taken in the Act was that a prejudicial loss of independent control might only be overridden by counterbalancing public benefits of greater significance. Thus the MMC were required to perform a balancing exercise, in situations where the MMC were satisfied that prejudice to the functions of the DGWS, by the loss of comparative information, would arise from a merger, and where there would be a reduction in the number of water enterprises under independent control. The companies argued that prejudice to the DGWS would only arise where the loss of comparative data would be such as to cause the use of comparative studies to be so materially impeded as to cause actual prejudice. In this context the parties considered that the value of comparative data should be assessed both quantitatively and qualitatively. Circumstances which might give rise to a reduction in the quantity of data might not, the parties suggested, reduce the quality of information available. This would be the case where new data were introduced which were qualitatively superior to that which had been lost.

9.53. The parties emphasised that the ability of the DGWS to make comparisons was not an end in itself, but part of his functions under the Water Act, in particular his duty to promote economy and efficiency among undertakers. Sometimes, the parties told us, pursuing economy and efficiency must of necessity result in some loss of comparative data. It was only where the marginal loss of comparative data was so significant as to result in prejudice to the DGWS that the balancing of section 30(3)(a) was required.

9.54. The companies suggested that any marginal loss of value in the comparative data available to the DGWS as a result of the proposed merger would not be such as to prejudice his functions under the Water Act. In particular, the parties argued that:

(a) A statistical analysis using data for the regulated activities of all appointed companies was the only practicable way of conducting relative efficiency reviews in line with the Government's objective of arm's length regulation.

(b) Such an approach would require the assessment of the effect on costs of both exogenous factors (those outside management control in the time period in questionsee Appendix 2.1) and efficiency factors. The proposed merger would result in some correlation of observations on efficiency, but need not result in loss of data required to assess the effects of exogenous factors. Indeed, the companies suggested that in the measurement of exogenous factors, the merged enterprise may provide purer observations, as a result of the elimination of the effects of joint working and the joint management of the Iver Works, which would be of wider benefit to the DGWS in conducting comparative studies. In particular, the parties told us that they would be prepared to undertake to analyse operating costs or profits on a divisional basis, along the lines of the existing three companies. Assuming that efficiencies were generated at the centre of the merged organisation and would therefore be expected to impact equally on all four divisions of the merged company, any differences between individual performances would be due solely to exogenous factors.

(c) Given that ten observations had apparently proved adequate in respect of efficiency studies on both sewerage and sewage treatment and disposal, the companies said that there was no reason to suppose that a larger number of comparators was required in respect of water supply. The companies told us that on the basis of their legal submissions the minimum number of water enterprises under independent control at the present time was 15 (taking into account known shareholdings and assuming all those where GU and SAUR had minority holdings were no longer under independent control). It was the parties' submission that this number would not be reduced by the proposed merger; the number of appointees would be reduced by the merger, but only marginally, from 39 to 37.

(d) The merger would produce an enhanced comparator, and would therefore provide data of superior quality to that which might be available from the companies without the merger.

9.55. The parties told us that they refuted the DGWS's suggestion that their geographical relationship played any role in determining the extent of any loss of comparative information. The DGWS's suggestion that the loss of information from mergers involving contiguous undertakings was more significant than from those involving non-contiguous undertakings was, the parties considered, at variance with the DGWS's other statements concerning the assessment of efficiency of individual undertakers being by comparison with the industry as a whole. It was also implicitly at variance with the point, with which the parties agreed, that cost comparisons and efficiency studies across the industry as a whole needed to take account of variations in operational environments. The parties considered that the merger need result in no loss of data required to assess such variations.

9.56. The parties also told us that they rejected as conjectural the DGWS's proposition that, with optimal information, he might be able to secure efficiency targets perhaps 1 per cent greater than would be the case if he were not able to properly distinguish between undertakers. The parties also said that the DGWS's evidence strongly implied that the existing number of comparators was the optimum and that the reduction in comparators implied by the proposed merger would give rise to information no longer being available to properly distinguish between different undertakers. They told us that even if it was the case that with optimal information 1 per cent greater efficiency targets could be secured, it could only be conjecture that the existing number of comparators was the optimum or that the proposed merger would lead to information no longer being available to properly distinguish between different comparators. It was also conjecture that the loss of any one comparator would lead to industry revenues in total increasing by 1 per cent. The parties said that the DGWS had provided no evidence to support these assertions but had started from the position that the existing number of undertakers should not be reduced.

9.57. The parties told us that they considered that the role of financial markets in providing a spur to efficiency and information on financial profiles was in practice unlikely to operate in the manner suggested by the DGWS. They did not accept that the same weight should be attached to these considerations as to those concerning costs and efficiency.

Benefits to customers and security of supply

9.58. We asked the parties whether, and to what extent, the proposed merger might bring about increased efficiency or improved service, for example in the form of lower costs or greater security of supply, in relation to the provision of water in the areas served by Colne, Lee and Rickmansworth. Much of the information the parties provided to us on savings and benefits likely to flow from the merger is set out in Chapter 4, Appendix 4.1 and in paragraphs 9.9 to 9.15.

9.59. The companies emphasised to us that the savings they had identified in their evidence to us were dependent on the merger, and that they were additional to the savings included in the efficiency targets used by DoE in setting initial K values.

9.60. The companies repeated their view that, under the new regulatory regime, the companies would be far less inclined to co-operate with neighbouring undertakers at the expense of their own customers and investors. It was to be expected that the Boards of independent companies would give paramount importance to the security of their own supply, which was a statutory responsibility under the Water Act. While bulk supply agreements might be entered into, it was in practice likely that periods in which bulk supply would be critical to the importer would also be critical to the exporter. Accordingly, it was submitted by the companies that it was unlikely that Boards would favour entering into contracts which either prejudiced their own customers' supply of water, or which might not be available in adverse supply conditions. A principal benefit of the merger was therefore the ability to integrate control of water resources over a wider region, making use of available water in the most effective way.

9.61. The parties told us that as well as the savings and benefits identified as resulting from the proposed merger, there were further savings which the companies had identified but which it had not been possible to quantify with any certainty. There were in addition further, qualitative aspects. These unquantified and qualitative benefits included:

(a) enhanced security of supply, especially in relation to water quality;

(b) greater self-sufficiency and flexibility in the use of water resources including the more efficient and effective use and future development of an integrated distribution network;

(c) an improved ability to deal with the demands of the new regulatory regime, including developing the skills needed to operate the `cost pass through' regime and adjustments to K;

(d) greater ability to recruit specialists in particular fields, as a result of the larger organisation, with the ability to offer enhanced career prospects;

(e) the ability to raise finance at keener rates of interest, as a result of the larger organisation and a lower perception of lender and shareholder risk; and

(f) the ability to take advantage of a larger supply area in terms of seeking opportunities to diversify away from the core water supply activities.

9.62. With regard to security of supply, the parties told us that it was axiomatic that a water undertaker required reliable supplies, in both quantitative and qualitative terms, and that consequently the long-term integration of water systems was the central logic of water business amalgamations. The water industry was capital-intensive, with a long planning horizon the companies told us that the gestation period for a large resource might be 15 years. Consequently the companies told us that it was often impossible to say with certainty what particular developments might be undertaken to improve security of supply by the merged enterprise in the future. The areas served by the separate companies at present did not have a material surplus of water resources, and therefore ensuring adequate future supplies was a matter of concern. The companies considered that dependence on one major source to supplement local sources was strategically weak. The merged company would, however, be able to develop a network without this weakness, as it would have a major complementary source in the North, Grafham, as well as one in the South, Iver. The companies would propose to develop a number of links to integrate their existing networks, which would enable water from both Iver and Grafham to be used conjunctively with existing aquifer water to meet increased demand, to enhance strategic security and to enable any water quality problems to be better managed. The resulting network would thus enable the optimal use of water resources.

9.63. The companies told us that the sort of integration of their networks as they were proposing would give it the robustness and flexibility needed to deal with potential supply failures, including those shortages which had led to hose-pipe bans by Lee and Colne in 1989. It would also help overcome the problems which arose if the high lift pumphouse at Iver needed to be shut for repairs (these could last up to five days, shutting off 25 per cent of the supply to Colne and Rickmansworth). It would also help overcome local problems caused by bursts or local supply failures, by providing alternative ways of moving water to meet demand and maintain supplies.

9.64. The companies emphasised to us that these developments, which would be of real benefit to customers, would not be possible if the three companies remained independent. Under the new regulatory framework, the operation of the sort of joint schemes envisaged by the companies would involve complex agreements dealing with the sharing of investment and operational expenditure, and setting out how resources were to be used in many different operational circumstances. Accordingly, the companies told us that they believed they would be disinclined to enter into such arrangements.

Water quality

9.65. We asked the parties to what extent the proposed merger might bring about improvements in the ability of the enterprises concerned to meet water quality standards, including EC standards, and to conduct water quality research in a more cost-effective way.

9.66. The companies told us that, while an integrated distribution network would give security against drought, pollution incidents or water main bursts, its contribution to the improvement of water quality on a day-to-day basis was more limited. In some cases quality might be improved by blending water to reduce contamination to conform to EC standards, but this was a realistic option only within areas with well-developed distribution systems.

9.67. The proposed merger would, however, improve the companies' ability to manage water quality, we were told. Hitherto, the companies have followed `best practice' in supplying drinking water, as set out in DoE's Guidance on safeguarding the quality of public water supplies. The industry is now obliged to comply with much more stringent requirements, given force in the Water Supply (Water Quality) Regulations 1989. The companies told us that, in common with many other water supply undertakers, they were not fully achieving the water quality standards required. Programmes of remedial works needed to ensure compliance had been agreed with the Secretary of State for the Environment. In many cases the three companies had possible or actual pollution problems, which they were presently unable to assess fully until further analytical monitoring had been carried out. Each water undertaker would need to devote staff to the task of developing systems to obtain, handle, record and interpret water quality data according to new, strict requirements for quality measurement set down in the regulations. The merger would enable the three companies to avoid triplication of effort, and to devote resources instead to the development of a qualitatively superior centralised scientific establishment. Such a facility would also be able to recoup some overheads by providing analytical services to outside partiessomething that the companies already did to a limited extent. The merger would also enable Colne and Rickmansworth, as well as Lee, to benefit from access to the research facilities of CGE, as well as the shared experience of CGE and its other subsidiaries in dealing with water quality problems. For all these reasons, the companies told us that they expected to reap considerable economies of scale and efficiencies in scientific services from the merger, which would assist in meeting water quality standards more quickly and effectively than would otherwise be the case.

9.68. We asked the parties whether they considered it would be possible for individual companies to contract their laboratory requirements out to third parties. This would have enabled economies of scale to be achieved without the merger. The parties explained that they considered it essential to retain direct control of laboratory services to enable them to decide priorities, which would not be possible if these tasks were carried out by a third party.

Employment

9.69. We asked the parties whether, and to what extent, the proposed merger might affect current employment and future employment prospects in the three water enterprises and for details concerning the arrangements which would be made for employees whose employment or conditions may be affected or terminated.

9.70. The parties told us that during the 1980s all three companies had made major efficiency gains through staff reductions. There was, however, limited scope for further savings; indeed additional staff would be needed by all three to cope with the new regulatory regime. The companies provided us with details of the reduction in the number of staff positions they expected to achieve if the merger proceeded (these are set out in Chapter 4 and Appendix 4.1). The companies told us they were confident that the reductions could be achieved through early retirement, voluntary redundancy and natural wastage, and that there would be no compulsory redundancy. The companies told us they did not consider that this loss of employment, managed without compulsory redundancy, was a matter of public interest concern.

9.71. The parties went on to tell us that the major employment problem the companies faced was the urgent need to recruit new skills which had not hitherto been required by the water industry, and to supplement existing skills. All three companies had persistent difficulties in filling vacancies in a number of areas:

(a) computing and electronic technicians;

(b) graduate civil engineers;

(c) specialist word processing and data processing staff;

(d) clerical staff for customer accounts;

(e) general accounting staff; and

(f) business planning specialists.

The proposed merger would, the parties told us, allow the recruitment of a single, more specialised team to deal with regulatory matters than would be possible if the companies remained independent.

9.72. The companies told us that, while it was possible to identify in financial terms the level of savings which might be achieved by staff rationalisation as a result of the merger, such estimates did not, they considered, give a picture of the benefits which would result in terms of job satisfaction and the ability of the merged organisation to recruit and retain high calibre staff in the very competitive employment market in the South-East. The companies told us that they believed the merged company would be more attractive to employees because of the improved training and career development opportunities. The merged concern would have greater scope for introducing employment initiatives which would attract a wide variety of employment groups.

9.73. The companies told us that the move to local negotiations following the disbandment of national bodies in the industry from 1 November 1989 was also significant for employment prospects. While it gave companies, even without the merger, the opportunity to develop new pay structures better reflecting performance and local conditions, it also placed a considerable burden on personnel management resources. Without the merger, the three companies would be hard pressed to develop the necessary agreements, and prepare for and conduct negotiations on employment issues without the extensive use of external services. In contrast, the merged concern would be able to develop its own centralised personnel management function with the necessary specialist skills.

The merged company's ability to raise capital

9.74. We sought the parties' views on whether and to what extent the proposed merger might affect the ability of the three water enterprises to obtain the finance to carry out necessary capital investment, and to what extent the costs of capital incurred by the three companies might be affected by decisions on the corporate structure and financing plans related to the proposed merger.

9.75. In response, the parties told us that Three Valleys would be better able to raise the additional capital required to maintain and develop its core business than each of the companies would be without the merger. In their negotiations with DoE over the setting of initial K values, it had been made clear to the companies that a substantial amount of new equity would be required in order to establish a sufficiently strong capital base to finance their capital expenditure requirements. The parties told us that they expected the costs of capital faced by the companies to change dramatically under the new regulatory framework, but that the full impact would not become clear until after the conclusion of the negotiations with DoE on K and on capital structure.

9.76. In order to raise significant amounts of additional equity capital, the companies told us that they would need to be seen as an attractive investment compared with both other water companies and the WSPLCs. They expected the merger to significantly enhance the investment attractions of Three Valleys as compared with the three individual companies. This could, we were told, be supported by the following considerations:

(a) Three Valleys would be the eighth largest water undertaker in terms of volume supplied;

(b) the marketability of Three Valleys shares would be enhanced by the increased liquidity which would result from the larger size of its share issue;

(c) as a larger company, Three Valleys might expect to receive more attention from analysts and investors, with a consequent further improvement in the marketability of its shares and thus the terms on which they might be issued; and

(d) as a larger company, Three Valleys might expect to have access to a broader range of equity and equity-linked financial instruments.

9.77. In addition to raising new equity capital, the parties told us that Three Valleys was likely to need to raise significant debt to complete its capital expenditure requirements. The parties told us they expected that Three Valleys would be able to raise more debt than the existing companies individually, and on better terms, because of:

(a) the ability of Three Valleys to raise equity more effectively and therefore to provide itself with a stronger capital base and reduced lending risk; and

(b) access to a broader range of financial instruments;

The parties told us that they would expect the merged enterprise to be able to secure more favourable terms for its debt although this would depend on the details and circumstances of the borrowing involved.

9.78. In addition, the parties told us they considered that the presence of CGE as a major shareholder in Three Valleys would both enhance the share price and reduce the cost of capital to the merged company, for the following reasons:

(a) the presence of CGE would reassure lenders of the long-term stability of the business;

(b) the market might believe that CGE would at some time seek to increase its holding, thus helping maintain the share price; and

(c) the general market perception of Three Valleys would depend in part on the ability of its management to plan and implement the capital investment programme it would need for its core business, and to undertake successful diversification. CGE would, the parties believed, exercise financial discipline and also provide considerable expertise in both the water business and in diversification, and consequently enhance the perception of Three Valleys in the eyes of the market.

9.79. The parties also told us that there were a number of instances where major shareholders in companies had underwritten capital-raising exercises at higher prices than would have been obtainable in the market.

9.80. The parties concluded therefore that they did not consider that the presence of CGE as a majority shareholder would tend to depress the share price for Three Valleys by removing the possibility of a take-over.

The balance of benefits against the loss of independent control

9.81. We asked the parties whether they considered that the benefits which were likely to flow from the merger were such that they might be expected to outweigh any loss to the DGWS's ability to make comparisons, if Colne and Rickmansworth were to cease to be under independent control as a result of the merger.

9.82. The parties reiterated their argument that no reduction in the number of water enterprises under independent control would occur as a result of the proposed merger, for the reasons set out in paragraphs 9.36 to 9.44. Even if it were assumed that a reduction in the number of enterprises under independent control had taken place, the parties argued that the marginal loss of value in the comparative data available to the DGWS as a result of the merger would not be such as to prejudice his ability to carry out his functions. In particular, the parties argued that there need be no loss of data for the purpose of assessing the impact of different operational environments on costs.

9.83. The parties went on to argue that, should the MMC conclude that a prejudicial loss of independent control had arisen, in assessing the detriment against the benefits of the merger, the MMC must assess the degree and extent of the prejudice in order to carry out what the parties argued was the balancing exercise envisaged by section 30(3) of the Water Act. This was, the parties told us, the only way in which it would be possible to assess whether the benefits of the merger were of `substantially greater significance'. Thus, if the prejudice were assessed to be marginal and not of significance, then the parties would, they argued, face a lighter burden in establishing that the benefits of the merger were of substantially greater significance than any deemed loss of independent control.

9.84. The parties told us that, even if the DGWS were prejudiced in carrying out his functions as a result of the merger, the purposes which the parties sought to achieve were indeed of substantially greater significance than the need to avoid any loss of independent control. The merger would produce substantial efficiency gains, which would have a material effect on K for each company over the next ten years. This was despite the fact that a cautious approach had been taken in identifying cost savings, in order to ensure that they could be properly substantiated. The parties told us that they expected further savings would be generated once the merger proposals were fully implemented which would go beyond those so far identified and evaluated. While these benefits could not be readily quantified in terms of K it was their view that they should not be excluded from the balancing exercise.

9.85. The parties told us they recognised that the customers of the three companies had a legitimate interest in the savings which might result from the merger. The companies told us they accepted that, as a result of a merger, a substantial proportion of these would be reflected in an adjustment to K, resulting in lower charge increases to customers. The companies were ready to negotiate to this effect with the DGWS if the merger were approved; they did not, however, believe that it was the DGWS's duty to ensure that all savings arising as a consequence of a merger should be passed to customers, nor did they consider that the effect on charge levels was the only factor to be considered in weighing the benefits of the merger against any prejudicial loss of independent control which might be established.

9.86. The parties concluded that, for the reasons set out in their legal arguments, there could be no loss of independent control arising from the proposed merger. Even if there were some loss, the parties considered that the prejudice to the DGWS's role arising from the merger would be marginal, and of no significance compared with the substantial benefits likely to be achieved from the merger.

Minority and non-voting stockholders

9.87. As part of our inquiry into possible public interest issues, we had asked the parties to what extent the interests of minority and non-voting stockholders might be affected by the proposed merger.

9.88. The parties told us that it was their intention to extend Three Valleys offers to all classes of share capital in the present company, the ownership of which was necessary to effect the merger. In due course, the parties also expected to make an appropriate offer for the permanent non-voting share capital of Rickmansworth. The non-voting preference shareholders would not be able to prevent a take-over.

9.89. The rights of the shareholders in each of the companies would not be varied by the making of the offersif these rights were to be varied, the provisions of sections 98 to 102 of the Water Act would mean that 75 per cent of votes cast of each class would be required, as well as overall approval of 75 per cent of stock voted.

Water charges

9.90. We also sought the parties' views on whether, and in what manner, any efficiencies which might accrue from the merger ought to be reflected in reduced water charges, or in greater remuneration for the shareholders of Three Valleys. We also asked the parties whether, and to what extent, the proposed merger might affect the level of water charges to customers in the area, including the appropriateness, timing and nature of any rationalisation of water charges if the merger took place.

9.91. In response, the parties told us that, in the past when local SWCs had merged, water charges had usually been equalised, typically after a five-year transitional period. However, they thought that this might no longer be a useful guide for the future having regard to the requirements of the Water Act.

9.92. The parties told us that it was necessary to consider whether charges under a merged concern should be equalised, which would result in differential increases for each of the three areas, or whether charges should continue to be based on the cost of supplying water to different areas rather than the merged unit as a whole. In fact, the operating costs per property supplied were very similar for all three companies, and the present differences in charges between them resulted from different finance and debt structures, and recent increases in charges in anticipation of high future investment levels.

9.93. The parties told us that the Water Act (section 7(3)(a)) provided that there should be no undue discrimination in the fixing of charges; this provision was reflected in the licence of appointment, which required the appointee not to discriminate against any class of customer. This condition would certainly affect any new Three Valleys charging schemes, whether or not the merged concern retained three separate appointments.

9.94. The companies told us that they would expect to discuss the charging regime with the DGWS if the merger were approved, on the basis that any charging scheme should reflect as accurately as reasonably practicable the costs of supplying water. In the longer term the companies would expect to look in more detail with the DGWS at cost-based tariff structures.

9.95. In response to the question of how the benefits should be distributed between customers and shareholders, and what sort of mechanism might be required to effect this distribution, the parties told us that this would also need to be the subject of discussion with the DGWS. There were, however, a number of ways in which an adjustment to K might be effected to pass benefits from the merger to customers, although the parties had no view on which might be the most suitable. These were:

(a) the making of a new appointment to replace the existing three undertakings with a single, unified undertaker. This would provide the DGWS with the opportunity to set a new K, taking the merger into account;

(b) through interim reviews by the DGWS of the existing appointments. The DGWS was able to conduct such reviews at five-yearly intervals;

(c) through the mechanism of `relevant change of circumstance'. This was a provision whereby changes in particular circumstances, previously defined in the licence, might be taken into account in an adjustment to K between reviews. The disposal of surplus property was such a circumstance; and

(d) through a system of voluntary price restraint. K provided, in conjunction with the RPI, an upper limit to price increases, which companies need not follow should their cost be below expectations. The parties commented, however, that they were aware that the MMC might wish to look to mechanisms for ensuring that any such restraint was adhered to, once it had been promised. The parties observed that the powers of Schedule 8 of the 1973 Act would be available for this purpose, although they would sit oddly, in the parties' view, with the central role of the DGWS in regulating the industry.

Possible remedies

9.96. In the course of our inquiry we asked the parties to comment on a number of possible conclusions, including adverse conclusions. We also asked the parties to comment on a number of possible draft undertakings which we had considered might be appropriate to remedy some of the adverse effects we had postulated. In response, the parties provided us with written representations and attended a hearing where these issues were considered further. Subsequently, the parties provided further technical information to illustrate their representations.

9.97. The possible draft undertakings upon which we had sought the parties' views were:

(a) That the parties would immediately seek a new single appointment for Three Valleys if the merger went ahead.

(b) That the parties would co-operate with the DGWS in providing information needed to set a new K value.

(c) That the parties would accept that the cost and interest savings from the merger should be taken into account either:

(i) wholly to the benefit of customers; or

(ii) as above, except for receipts from property disposals, where half would be returned to shareholders.

(d) That, for the first ten years after a merger, no class of customer should unreasonably have to pay more than would have been the case had the merger not occurred.

(e) That the parties maintain the present company areas as separate profit centres, and provide the DGWS with profit information to help him in drawing comparisons.

(f) That the parties recognise appropriate trades unions, preserve the pension rights of existing employees, and implement their existing redundancy arrangements, including no compulsory redundancy as a result of the merger.

(g) That the parties provide the DGWS and the DGFT with the information needed to negotiate and review the undertakings.

The parties' response

9.98. In response to these proposals the parties made a number of general points. They told us that they did not consider the case to be one where undertakings were necessary, as they believed that the merger proposals would not operate against the public interest. The parties were sympathetic to the

view that, in performing any balancing exercise under the provisions of section 30(3)(b)(ii) of the Water Act, the MMC would need to be satisfied that benefits would flow as a result of the merger, and that benefits (including, but not limited to, savings) would flow through to customers. The parties emphasised that there were considerable long-term savings and benefits, many of which were unquantifiable, which they considered would flow from the merger.

A single appointment and the apportionment of merger savings

9.99. The parties told us they considered that, with the common control which would result from the merger, the bulk of the savings could be achieved whether or not the existing three individual appointments were replaced by one new appointment. The parties told us that one of the central objectives of the regulatory regime was to achieve the same balance between customers and the appointed company as would occur in a competitive market. In this regard, the parties considered it to be a fundamental principle that incentives should exist for appointed companies to act efficiently and to seek savings; such incentives would only exist if shareholders received a portion of the savings achieved.

9.100. The companies told us they considered that the regulatory regime provided the DGWS with all necessary powers to take the benefits of the merger into account at an interim review after five years; it was only in relation to savings generated before that time that he lacked the necessary powers. At the same time, the parties told us they expected that the merger would necessarily take several years to implement. This would mean that the substantial savings which the merger would create would only begin to appear in net terms in the fourth year after the merger. It was therefore, the parties argued, only in relation to years 4 and 5 after a merger that the regulatory regime would not enable the DGWS to pass the benefits on to customers.

9.101. The parties went on to reiterate their observation that the water industry was a long-term one, both in its planning horizons and the period over which the benefits of the merger would be realised. Accordingly, the parties told us they considered that to focus only on the benefits realised over the relatively short term ignored the wider strategic and public interest benefits the merger would bring. The companies told us that to proceed too quickly to a single appointment would be an inefficient use of resources, as a considerable administrative burden would be imposed on them if they were obliged to negotiate a new appointment at the same time as they were implementing the rationalisation programme.

9.102. The companies told us that they would be in great difficulty deciding what advice to give their shareholders in relation to the merits of the Three Valleys offer if they were obliged to embark on negotiations for a new appointment immediately following a merger. This was because knowledge of a company's K value was essential to an assessment of its profitability, and considerable uncertainty would result until this was known. The parties would be concerned if they were obliged to make a commitment to move to one appointment immediately following a merger.

9.103. The parties told us that it would be unreasonable to treat the three companies differently from other water undertakers as regards the proceeds of property disposals. Consequently, the parties considered the proposal in draft undertaking (c) (see paragraph 9.97), that all the benefits of the merger, including those from property disposals, should be returned to customers, to be one which would unfairly prejudice the companies. As far as the other savings were concerned, the companies told us they considered that the passing on of 100 per cent to customers with immediate effect following the merger would substantially diminish the incentive for the shareholders in each of the companies to agree to the merger. If the balance between customers and shareholders were to tip so far in favour of customers that there was no incentive left for shareholders to proceed, and the merger was consequently abandoned, it would be to the detriment of customers as they would be deprived of the benefits which the companies believed would flow from the merger.

9.104. We asked the parties whether there would be any difficulty in implementing the merger (and thus realising the savings) if the three SWCs remained as separate entities, possibly with minority shareholdings. The parties told us they were confident that the merger could be made to work in such circumstances; they were confident of securing the support of enough shareholders to

establish the necessary common control. The companies were aware of the ring- fencing provision of the existing licences, but considered that it would be possible to meet these conditions and still establish common central services, possibly outside the regulatory environment. At the same time, the parties reaffirmed their firm intention to move to a single licence by the time of a first interim review.

Transfer of appointments

9.105. We put to the companies the DGWS's view that it would not be necessary for a new appointee for the Three Valleys area to own the assets needed to run the water businesses of three companies. He had suggested that since the important issue was access to the assets, some form of management agreement between the companies would be sufficient.

9.106. The companies told us they believed, however, that the Water Act required that a company holding an appointment under the Act should have vested in it the assets needed to carry out its responsibilities as a water undertaker. This view had been confirmed by leading and junior counsel, who had advised that the nature of the duties imposed by the Water Act on water undertakers (for example, the fundamental obligation, under section 37, to develop and maintain a system of water supply in their area of appointment) required that the appointee and the owner of the network assets be one and the same. This requirement would not, the companies told us, be satisfied if the appointee and owner of the undertaking were separate companies within the same group.

9.107. The parties went on to observe that, although this principle was not expressly stated in the Water Act, the following considerations arose from the provisions of the Act and appeared to support their view:

(a) It was implicit in the Act's provisions relating to `protected land' that the company holding an appointment as a water or sewerage undertaker has vested in it the land necessary for the carrying on of its functions (see section 152(2) of the Act and the definition of `protected land' in section 189).

(b) It was also implicit in other duties imposed, or rights conferred, on water undertakers that network assets were vested in the undertaker. For example, section 165 (1)(a) imposed a duty to keep records of mains vested in the undertaker and section 167 created a criminal offence of interfering with mains, pipes etc vested in a water undertaker.

(c) The procedure for transfer of appointments, to the extent that they were outlined in the Water Act, confirmed that the transfer of an appointment also entailed the transfer of the existing appointee's undertaking. For example, section 12(4) referred to the terms on which a new appointee can accept the transfer of assets from an existing appointee.

Separate appointment of contiguous, jointly-managed water undertakings

9.108. We asked the parties to comment on the possible argument that the Water Act envisaged that a water supply business should have a single appointment and that there was no provision in the Water Act for separate appointments for businesses which are contiguous and managed as a single operation.

9.109. The parties replied that they believed that no such conclusion could be drawn from the absence of such a provision in the Act, and that on the contrary this view was inconsistent with the provisions of the Act, having regard to the following reasons:

(a) Section 11(4) of the Act required the Secretary of State to make such appointments as secured that, on the transfer date, each SWC became the water undertaker for the area it served immediately before that date. The section contained no qualification regarding water undertakings which were both contiguous and commonly managed.

(*b*) The Act set out the limited circumstances in which an existing appointment may be terminated or transferred (namely, with consent, or by at least ten years' notice expiring not earlier than 25 years after the transfer date, or through the making of a special administration order on one of the grounds set out in section 23). The companies considered that there was no mechanism under the Act for the termination (other than by consent) of an existing appointment on the grounds that two separately appointed, contiguous undertakers are or have come under the same management.

The parties told us that they were aware of at least one situation in which contiguous SWCs (West Kent and Mid-Sussex) were under common management and ownership on the transfer date, and which were appointed, separately, as water undertakers with effect from the transfer date. Such appointments could not, the parties told us, have been made if the Water Act did not permit the separate appointment of contiguous, jointly-managed companies.

The parties' alternative proposals

9.110. The parties offered, as an alternative to draft undertakings (a) to (c) in paragraph 9.97, an alternative proposal. They reiterated that while it remained their intention to move to a single appointment about the time of a first interim review of K, there were practical difficulties in making a commitment to do so by a given time.

9.111. The parties provided information on the likely minimum period necessary for the offer process and a move to a single appointment to be completed. This suggested that it would be unlikely that a single appointment would be in place before February 1991. For practical purposes, this would mean that a charging scheme reflecting a unified K could not be operative until the charging year 1992/93.

9.112. Furthermore, the parties told us they did not believe that the setting of a new K would be straightforward. They accepted that the areas of uncertainty might be minimised if the new K were to be set within a period of a few months following the initial determination of K for the separate companies, and if it were to be set using the projections and assumptions used by DoE in that initial process, subject only to inclusion of merger savings and consequent adjustment of the financial profile. However, they considered that a more wide-ranging reassessment (which might be envisaged by the DGWS), even in the very short term, would lead to increased uncertainty and complexity. Any delay in the process beyond the first few months following the initial determination of K could only result in further uncertainty. Such uncertainty could result from the need to:

(*a*) prepare financial projections for the new undertaking, including the benefits of the merger, and taking account of revised asset management and surface investment plans;

(*b*) agree the bases and common central assumptions on which these projections will be based including in relation to efficiency factors; and

(*c*) agree the amount of new equity to be raised and the basis on which the financial profile will be assessed.

First claims for `cost pass through' would, the parties told us, need to have been submitted by all undertakers by 1 October 1990 and annually on that date thereafter. Such claims would require the DGWS to reassess the level of K in any event.

9.113. The parties told us that they had considered whether, in relation to the move to a single appointment, they might be prepared to offer some form of undertaking, even in qualified terms, as opposed to confining themselves to the existing confirmation that their aim is to move to one appointment by or at the time of the first periodic review of K. The parties told us that (assuming such an undertaking were necessary) they would be prepared to undertake:

to seek to put forward for the approval of their shareholders, the Secretary of State or the DGWS (as appropriate), and any other relevant parties such proposals (including all relevant documentation) as may be necessary to enable them to achieve a single appointment to be operative for the charging year 1995/96 (the first year in which the periodic review of K would apply).

The parties told us that their suggested possible undertaking was put forward in qualified terms because this would involve the first merging of appointments under the Water Act, and the first amalgamation of SWCs since the repeal of the relevant provisions of the Water Act 1945. Consequently, there was a considerable degree of uncertainty as to the precise mechanics involved. The mechanism contemplated under the Water Act 1989 for the transfer of assets is set out in Schedule 5 of the Water Act, which would require the approval of the Secretary of State or the DGWS. It would be necessary to determine the appropriate consideration for the transfer of the undertakings, to obtain the necessary consents (including those required by the Stock Exchange rules) and to effect any necessary changes to the constitutions of the SWCs. On the basis of professional advice the companies were confident that all necessary consents could be obtained within the first five years. However, they were concerned that any requirement to do so earlier could materially constrain their ability to implement their proposals in the optimum manner and might further complicate the formulation of the offer. The companies' alternative proposal was intended to provide customers with benefits from the merger within the first five years, whilst maintaining for the companies the flexibility required to move to a single licence by 1 April 1995.

9.114. The parties told us that if the MMC were to recommend undertakings leading to a single appointment by or at the time of the first interim review of K, the parties would be prepared to offer to pass to customers, prior to that time, a portion of the value of the benefits of the merger, as follows:

(a) Half of the forecast operational savings, the savings from capital deferrals and cancellations and better borrowing terms would be used to reduce the level of increase in charges to below K for each of the companies. This reduction would occur in the year in which each of the savings was projected to arise and would be made irrespective of whether or not the forecast savings were fully achieved.

(b) Half of the actual net balance of one-off savings and costs including those arising from property disposals would be used to reduce increases in customers' charges in the charging year following that in which the property disposals were completed. The use of actual rather than anticipated savings reflected, in the main, uncertainties in assessing property realisations.

The parties confirmed to us that they would also be prepared to enter undertakings to implement these proposals, which would also obviate the need to recalculate K or move immediately to a new appointment. The parties told us that this arrangement would operate for about five years, until the time of a first interim review of K, when they would also expect to move to a single appointment. It would enable them to offer their shareholders some certainty for the first few years after a merger, and thus make it easier to both formulate and recommend the terms of the offers. Details of the possible effect of this proposal on water charges are in Appendix 9.1.

9.115. The parties told us that they remained of the view that a move to a single appointment before a first interim review would provide no significantly greater benefit than a move at that date. In practice, a charging scheme for a new appointee was unlikely to be in place before the charging year 1992/93, only three years before the review. The parties agreed that their proposals for the treatment of the benefits of the merger over the first five years did not allow for the effects of financial reprofiling, which might alter K. They observed that financial profiling could either increase or decrease K, and was judgmental, dependent on the assumptions made on the requirements for new capital and other factors which sought to strengthen the financial position of the companies as plcs in comparison with their relatively highly-geared status as SWCs under the previous regulatory regime. Consequently, the companies were unable to assess the likely effect on K that re-profiling would produce although, given the particular circumstances which would apply in the first five years, they did not believe that the effects would be significant. They argued that, in any event because of the judgments involved, the effect of re-profiling was unquantifiable and therefore they did not consider

that it could be taken into account by the MMC in assessing the benefits of the merger in the first five years.

9.116. The companies also considered that it would impose an unnecessary burden and further cost on them if they were involved in the negotiation of a new K when that new K would only be likely to be in effect for about three years before a periodic review of K might be due to take place in any event.

9.117. Alternatively, the companies also suggested that if a new single K was set in 1991, to take effect in the year 1992/93, and that new K were to run for ten years (with a periodic review after five years), this would mean that their review date would be substantially out of line with the review dates for other water companies. The companies considered that this might be disadvantageous for the DGWS and for themselves, for example, in the context of setting efficiency targets.

9.118. In presenting their proposals for passing on the savings and costs of the merger they included an estimate of the professional costs incurred by the companies in developing the merger proposals, including the costs of the MMC inquiry. The companies were, we were told, negotiating with DoE about the inclusion of these costs in setting K for each company, or their treatment as notified items. The companies told us that, to the extent that these costs were not allowed by DoE, they should be allowed as costs in assessing the net balance of one-off savings flowing from the merger, as it would be unreasonable for customers to participate in the benefit of the savings without contributing to the costs incurred in creating them.

9.119. The companies told us that they thought it would be unfair and unreasonable if they were denied any reward or incentive for having identified and achieved the savings in the first five years. They regarded a 50:50 apportionment of the net savings in the first five-year period as reasonable. It would also be consistent, they told us, with the existing policy for the disposal of surplus land, and formed the basis of the parties' alternative proposal. They told us that, in formulating the merger proposals generally, they had put their customers first. Their alternative proposals were a practical and sensible way of distributing the benefits of the merger, taking into account the costs involved and the companies' own needs.

9.120. We asked the parties whether their view on the distribution of the assured savings was reasonable, given that the shareholders would in any case benefit from many of the unquantified (but nevertheless tangible) benefits the parties had told us the merger would bring, as well as from the enhanced opportunities for diversification which Three Valleys would enjoy. The parties replied that many of the further benefits were long-term ones, in which consumers would share as a result of periodic adjustments to K. In addition, they told us that their shareholders would bear the risk of any diversification beyond the core business (which was itself protected), while the income from these activities would contribute to central overheads, to the benefit of both consumers and shareholders.

Charges to customers

9.121. The parties told us that they agreed it would be unreasonable if any class of customer was required to pay more in charges than would have been the case without the merger. This view was, however, subject to any significant reappraisal of tariff structures which might be required by or agreed with the DGWS. The companies would expect to agree the basis for tariffs within a merged undertaking as part of related negotiations on a single appointment. Prior to the determination of a new appointment, the companies expected that tariffs would continue to be based on existing appointments, subject to the apportionment of merger savings between the three companies (on a basis which they would expect to be agreed with the DGWS). The parties also told us that the possible draft undertaking we had supplied on this point would, if effected, require the merged company to make a theoretical assessment of what charges would have been had the merger not taken place. This would, they considered, be impractical. In any case an undertaking of this sort would not be necessary, the parties told us, if their alternative proposals for the distribution of benefits were accepted. If an undertaking were given, it should not extend beyond the first review of K.

The provision of divisional accounting information to the DGWS

9.122. The companies told us that they could undertake, following a merger, to provide the DGWS with operating cost information on a divisional basis along the lines of the three existing companies. They had also agreed in the course of a hearing that they would be prepared to provide such divisional data on a profit centre basis (this would be required in any case to support divisional tariffs). The companies told us they considered that separate divisional cost data were likely to be more use to the DGWS in conducting comparative studies by assessing the effect on costs of exogenous factors. Separate profit centre data, which would include allocations of central overheads, would tend to lead to increased correlation of divisional observations, and hence reduce the value of divisional data. The parties commented that undertakings on these bases would only be relevant in respect of a single merged undertaking.

Employment

9.123. The companies told us that they had always attached considerable importance to maintaining good relations with their employees; indeed, one of the benefits which they considered would flow from the merger would be enhanced opportunities for employees in a larger organisation. The companies had made it clear from the outset that the merger would not give rise to compulsory redundancies or adversely affect employees' conditions:

(a) in the press release of 27 July 1989 announcing the proposed merger, the companies had said that there would be no compulsory redundancies and that the rights and conditions of employment of management and employees would be fully safeguarded, including existing pension rights; and

(b) the question and answer sheet given to employees at the time of the merger announcement made similar statements.

9.124. The companies told us they believed that these reassurances went beyond the statements usually made in the context of a merger. Although they did not deal specifically with the question of union recognition, the Boards of the companies had accepted as a matter of policy the advantages of affording negotiating rights to appropriate trades unions. This had recently been reflected in an exchange of letters between the companies and the unions representing their employees setting out assurances from the companies that:

(a) there would be no compulsory redundancies arising from the merger proposals;

(b) any early retirements arising as a result of the merger would be on terms in accordance with the existing arrangements;

(c) existing pension rights and benefits of existing employees would not be adversely affected by the merger; and

(d) the companies would continue to recognise appropriate trades unions.

Appendix 9.2 sets out the text of the companies' letter. Consequently, the parties told us they considered that no adverse effects in relation to the public interest would arise from the implementation of the merger proposals.

Provision of information to the DGWS and the DGFT

9.125. The parties told us that they would have no objection to the usual undertaking in the event that the MMC's report contained recommendations for undertakings to provide the DGFT with such information as is reasonably necessary to enable the undertakings to be negotiated and their implementation to be kept under review. In so far as the proposed undertaking applied also to the provision of information to the DGWS, the parties told us they considered that the DGWS had sufficient powers under the Water Act and the terms of the licences to obtain the necessary information.

Advance Corporation Tax (ACT)

9.126. In the course of our hearing with the parties to consider the draft possible undertakings, the parties drew attention to the fact that the three existing SWCs had paid a considerable amount of ACT, totalling £10.84 million, all or most of which they might be unable to recover if the companies moved immediately to a single appointment. They told us that a period of operation as three separate undertakings would be needed to enable this credit to be used. The companies' proposals for implementation of the merger and realisation of savings had assumed that such an arrangement would be in place for the first five years. In connection with the issues raised by the inquiry concerning a possible requirement to move to a single appointment over a shorter period, the parties had considered it necessary to draw attention to the ACT implications of such a move.

9.127. The parties told us that ACT is due on gross dividends paid by a company, at a rate equal to the basic rate of income tax. This payment may be offset against the company's corporation tax liability, up to a present annual maximum of 25 per cent of taxable profits. If the company has insufficient taxable profits to absorb the ACT it may be carried forward and recovered against corporation tax on future profits (including those arising on capital gains). The parties emphasised that the ACT credit built up by a particular company might only be set against that company's corporation tax liability.

9.128. The parties considered that if the three existing SWCs became dormant (because their appointments and assets were transferred to a single undertaking) their accumulated ACT would be lost, because in order for the ACT to be preserved the three companies must continue to make taxable profits.

9.129. We asked the companies for details of their profit forecasts for the next five years, to determine the extent to which they might incur a liability for mainstream corporation tax, and thus be able to use any ACT credit. In response, the parties told us that they had conducted an exercise using data from the companies' Books of Numbers (used for K-setting) which indicated that there was a reasonable prospect that the ACT they had paid might be utilised over the next five years. This exercise had necessarily involved a number of assumptions, including assumptions about the tax treatment of fixed asset disposals and additions and infrastructure renewal costs, and the assumption that no further dividends would be paid by the SWCs after 1 April 1990 on which an ACT liability would arise (ie that Three Valleys would begin to pay out dividends on group profits after that date).

9.130. The parties reiterated their belief (set out in paragraphs 9.105 to 9.107) that it would not be possible for the existing SWCs to continue as separate entities, with management agreements with Three Valleys as a single appointee. However, even if such an arrangement were possible they told us that it was most unlikely to prevent the loss of ACT. This was because of certain anti-avoidance provisions contained in the Taxes Act 1988. These, the parties told us, applied to a company when there was a change of ownership and thereafter a change in the nature or conduct of the trade, and would result in the loss of ACT carried forward at the date of change of ownership. It was the companies' view that the arrangement envisaged was such as to constitute a change in the nature or conduct of the trade.

9.131. We asked the parties to comment on any wider public interest issues raised by the question of ACT (although the issue was one the parties had raised in the context of their representations on remedies). In response, the companies told us that surplus ACT had accumulated

because of their low past corporation tax liabilities, especially before 1984, when they could claim 100 per cent first year allowances on plant and machinery. More recently, the companies had begun to incur mainstream corporation tax liabilities, and thus utilise their surplus ACT. The parties explained that the utilisation of surplus ACT would result in a credit to the taxation charge in each company's profit and loss account, thus increasing revenues, with a consequent increase in the current resources of the company.

9.132. The parties explained that once the merger was implemented a move to merge the appointments either immediately or in a matter of a year or two would result in the loss of their ability to utilise the outstanding ACT. This could result in a higher tax charge in the accounts although the actual effect was dependent on a number of variables. They told us that any such increase in the tax charge of the single undertaking could result in a weaker financial profile and possibly in a higher K. This would be needed to offset the reduced dividend cover resulting from a higher total tax charge. In any event the parties' proposals to retain separate companies for the five years to 31 March 1995 should, they estimated, result in the surplus ACT continuing to be available beyond that date. This was on the assumption that, at that time, the undertakings were to be merged. This was because the outstanding ACT of the three companies would have been used and replaced by ACT arising on dividends paid by Three Valleys.

9.133. If they were required to move immediately to a single appointment, the parties told us that they would consider using one of the existing companies as the new undertaker, thereby seeking to preserve some of the outstanding ACT.

9.134. In conclusion, the parties told us they believed that any requirement to move to a single appointment immediately after a merger would operate against the public interest as it could increase the K value in the period immediately after a merger and would, in any case, lead to the loss of all, or a majority of, the outstanding ACT. Conversely, the ability to utilise the ACT could improve the profitability of Three Valleys to the benefit of shareholders and customers and was, therefore, a further public interest benefit.