

Mid Kent Holdings plc
and
General Utilities PLC and SAUR Water Services plc

A report on the proposed merger



MONOPOLIES AND MERGERS COMMISSION

**Mid Kent Holdings plc
and
General Utilities PLC
and
SAUR Water Services plc**

A report on the proposed merger

**Presented to Parliament by the Secretary of State for Trade
and Industry by Command of Her Majesty
January 1997**

Members of the Monopolies and Mergers Commission as at 9 December 1996

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Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests. The omissions are indicated by a note in the text.

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Part I

Summary and Conclusions

1 Summary

1.1. On 21 December 1995 General Utilities PLC (GU) and SAUR Water Services plc (SAUR) announced their intention to make a bid for Mid Kent Holdings plc (MKH). MKH holds 99.9 per cent of the shares of Mid Kent Water plc (MKW). GU and SAUR currently have voting shareholdings of 19.45 per cent and 19.39 per cent respectively in MKH. GU also has shares in a number of other UK water companies, including Folkestone & Dover Water Services Limited (FDWS), whose area adjoins that of MKW, and where it has a 74.1 per cent shareholding. SAUR has two water subsidiaries in the UK: South East Water Services plc (SEW), which also adjoins MKW and is wholly owned, and Mid Southern Water plc, where SAUR owns 99.5 per cent.

1.2. MKW, SEW and FDWS supply water to a population of 1.3 million in most of Kent and East Sussex and part of West Sussex, one of the driest areas in England. The other main supplier of water in Kent and Sussex is Southern Water Services Ltd (SWS). We term the water supply areas of FDWS, SEW, MKW and SWS within Kent, East Sussex and West Sussex 'the region'. SWS is also a sewerage undertaker and provides sewerage services to the customers of FDWS, SEW and MKW.

1.3. GU and SAUR have formed a joint venture company to bid for MKH. Their proposals are complex. Under the terms of the Joint Venture Agreement (JVA) dated 20 December 1995 GU and SAUR agreed that once the share capital of MKH had been acquired at Stage 1, they would divide its principal operational area into two parts of approximately equal value (see Appendix 2.1). The western half (MKWest) would be merged with SEW and the eastern half (MKEast) would be merged with FDWS (Stage 2 of the proposals). Certain of MKW's water resource assets, chiefly abstraction licences and supply rights from third parties, would remain under the joint control of the enlarged SEW and FDWS. A Joint Resources Company (JRC) would be set up for this purpose.

1.4. Under our original terms of reference dated 23 May 1996 (see Appendix 1.1) we are required to decide whether arrangements are in progress which, if carried into effect, will result in the creation of one or more mergers of two or more enterprises as are required by section 32 of the Water Industry Act 1991 (the 1991 Act) to be the subject of a merger reference.

1.5. Our terms of reference were varied on 13 September 1996 (see Appendix 1.1), extending the scope of our inquiry to consider, in addition, whether there was an existing merger in place.

1.6. So far as any *existing merger* is concerned, we find that GU and SAUR have not been acting together to exercise control of MKH. However, we conclude that GU and SAUR are associated persons as defined in section 77(4) of the Fair Trading Act 1973 (the FTA) by virtue of the fact that they are acting together to secure control of MKH as a result of entering into the JVA. This means that for the purpose of section 65 of the FTA they should be regarded as one person. We find that their combined shareholding of almost 39 per cent confers the ability

materially to influence the policy of MKH. However, in the very special circumstances of this case we conclude, using the discretion conferred upon us by section 65(3) of the FTA, that GU and SAUR should not be treated as having control of MKH for the purposes of sections 65(1) and 65(2) of the FTA.

1.7. We do not find that either GU or SAUR individually has the ability materially to influence the policy of MKH.

1.8. Accordingly, we conclude that there is no existing merger.

1.9. So far as the issue referred to in paragraph 1.4 relating to the *proposed arrangements* is concerned, we examined carefully the details of the proposed arrangements, the action taken by GU and SAUR to further the proposals and the value of the assets of the water enterprises controlled by GU, SAUR and MKH. We conclude that arrangements of the type described in paragraph 1.4 are in progress.

1.10. In considering whether the proposed arrangements may be expected to operate against the public interest we are required by section 34(3) of the 1991 Act to have regard to the desirability of giving effect to the principle (the comparator principle) that the Director General of Water Supply's (DGWS's) ability to make comparisons between different water enterprises should not be prejudiced. Comparative competition underlies the regulation of the water industry in England and Wales by the DGWS.

1.11. MKW is currently one of only five remaining independent water-only companies (WoCs) of a size that the DGWS finds useful for comparative purposes. MKW has improved its performance over recent years and does now seem to have the potential to reach the efficiency frontier in terms of operating costs. At Stage 1 of the proposals the loss of MKW as an independent comparator would materially affect the quality of comparative data available. At Stage 2, the complete loss of MKW would significantly reduce the amount of data available to the DGWS. We conclude, therefore, that the proposed arrangements would prejudice the ability of the DGWS to make comparisons between different water enterprises. This detriment, although difficult to quantify, is, in our view, substantial.

1.12. We also find that the proposed arrangements would lead to reduced prospects for competition within the region.

1.13. GU and SAUR argued that their proposals would have substantial benefits and would result in much improved management and use of water resources in the areas of the three companies. Their plans included new infrastructure which they argued would improve security of supply by facilitating the transfer of water from areas in surplus to those in deficit, better conjunctive use of water sources and new programmes for metering, leakage reduction and customer education. We recognize that there is a problem for FDWS and SEW over the availability of water resources in the region.

1.14. Section 34(3)(b) of the 1991 Act requires us to have regard to the desirability of achieving any 'other purpose' so far only as we are satisfied:

- (a) that it can be achieved without conflict with the comparator principle; or
- (b) that the achievement of that 'other purpose' is of 'substantially greater significance in relation to the public interest than that principle and cannot be brought about except in a manner that conflicts with that principle'.

1.15. We consider that the benefits that will derive from the proposed arrangements are not

as great as was claimed by GU and SAUR, especially since most of the surplus water in the region is controlled by SWS, not MKW. Moreover, the bidders have been reluctant to negotiate bulk supply transfers (BSTs) and have not made use of the existing powers of the DGWS to order supplies and settle terms where negotiations have failed. We conclude that, even taking all of the benefits into account (whether or not they can be achieved otherwise than by a merger), the achievement of those benefits is not of substantially greater significance than the comparator principle.

1.16. We conclude that the proposed acquisition of MKH by GU and SAUR may be expected to operate against the public interest, with the particular adverse effects of prejudice to the DGWS's ability to make comparisons between different water enterprises and reduced prospects for competition in the region. Even if we were to take into account all the benefits of the merger the detriments would not be outweighed by these benefits.

1.17. We are required under section 72(2) of the FTA to consider what action should be taken to remedy or prevent those adverse effects.

1.18. The DGWS told us that the detriment of prejudice to his ability to make comparisons might be remedied through a package of measures designed to compel the newly-merged companies (MKWest and SEW and MKEast and FDWS) to become exemplary comparators, coupled with immediate price reductions.

1.19. MKH argued that the merger should be prohibited outright.

1.20. GU and SAUR argued that there would be no major detriment to comparative competition. Price cuts were an inappropriate remedy in view of the amount they were proposing to spend to achieve the benefits of the merger.

1.21. It was clear to us that the efficiency gains achievable through the proposed arrangements were small. In view of this, large price reductions would not be sustainable in terms of long-term cost reductions and were therefore an inappropriate remedy. The benefits would last only until the next Periodic Review, whereas the damage to the comparator regime arising from the loss of an independent WoC would be permanent.

1.22. We consider, therefore, that in this case the proposed merger should be prohibited.

1.23. Finally, we recognize the water resource difficulties FDWS and SEW face. If all the water undertakers in the region were prepared to co-operate one with another and with the two regulators we have no doubt that satisfactory long-term solutions could be found which would benefit the consumer. The DGWS and the Environment Agency (EA) have between them the necessary powers and influence to help develop such solutions. They should make every effort to do so.