

CALCULATION OF TURNOVER OF
A WATER ENTERPRISE

Government Response to
the consultation document
on calculation of turnover
of a water enterprise for
the revised water merger
regime.

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dti

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Government response to the consultation document on calculation of turnover of a water enterprise for the revised water merger regime

EXECUTIVE SUMMARY

The Water Industry Act 1991 (WIA91) has been amended by the Enterprise Act 2002 (“the Enterprise Act”) to align it more closely with the Enterprise Act’s general merger provisions. One of the changes made is the replacement of WIA91’s qualifying threshold for a mandatory reference for mergers of water enterprises based on asset values with a qualifying threshold based on turnover. This consultation was to seek views on Regulations to be made under section 34(4) and (5) of the WIA91 (“the Draft Regulations”) which will determine how to calculate that turnover.

Most consultees were content with the proposals. There were three main areas of comment. A number of respondents expressed uncertainty about the concept of including, when calculating turnover for the purposes of section 33(1)(a) of the WIA91 (as amended by the Enterprise Act), the turnover of a water enterprise in which a “material influence” is held. Some questioned whether it would result in the inclusion of water enterprises in which a very minor interest was held. Secondly, one respondent suggested that this test should also apply to determine the water enterprises considered for purposes of section 33(1)(b) of the WIA91. Finally, a number of respondents commented on the level of the turnover threshold, £10 million, suggesting it needed to be raised.

The government will lay the Turnover Regulations substantially in the form in which they were consulted upon. The question of the threshold level was outside the scope of the consultation and the vires for the Turnover Regulations.

Government response to the consultation document on calculation of turnover of a water enterprise for the revised water merger regime

Background

The Water Industry Act 1991 (WIA91) put in place a special merger regime for mergers between water enterprises. Sections 32-35 of the WIA91 include provisions requiring the mandatory reference to the Competition Commission of mergers between two or more water enterprises. At present, a qualifying merger is one where the value of the relevant water assets being taken over or the value of the relevant water assets of each water enterprise belonging to the acquirer exceed £30 million.

The Enterprise Act made changes to how all mergers are regulated, and included amendments to the WIA91 merger provisions. These amendments will align the water merger regime provisions more closely with the Enterprise Act general merger provisions (with independent competition authorities being determinative on merger cases). Many concepts stay the same: for example the regime still deals with mergers between two or more water enterprises. A water enterprise is an enterprise carried on by a company appointed under section 6 of the WIA91¹ to be a water undertaker or a sewerage undertaker; the Secretary of State has the power to appoint undertakers, and can give a general authorisation to the Director General of Water Services to make these appointments. The most important change in the regime for the purposes of this consultation is a change from an assets threshold to a turnover threshold for determining whether a merger between water enterprises qualifies for a mandatory reference to the Competition Commission. Two turnover thresholds are set out in section 33(1) of the WIA91 (as amended by the Enterprise Act): one threshold is the turnover of the water enterprise being taken over, the other is the turnover of each water enterprise belonging to the person making the takeover. The turnover threshold for each test is set at £10 million, which is expected to catch the same number of water enterprises as the £30 million assets threshold.

The amendments to sections 32-35 of the WIA91 contained in section 70 of the Enterprise Act will be brought into force on 29 December 2004. The purpose of this consultation was to seek views on the Turnover Regulations which will determine how the turnover of water enterprises is to be calculated for the purposes of the section 33 of the WIA91.

The draft drew heavily on the Order that determines how the turnover of an acquired entity is calculated under the general merger provisions of the Enterprise Act² (“The Enterprise Act Turnover Order”). The Turnover Regulations contain additional provisions needed for calculating the turnover of any water enterprise

¹ Sections 6 and 35(1) of the WIA91, the latter inserted by section 70 of the Enterprise Act and amended by paragraph 27(2) of schedule 7 to the Water Act 2003.

² [The Enterprise Act 2002 \(Merger Fees and Determination of Turnover\) Order 2003 \(SI 1370/2003\)](#)

belonging to the person making the acquisition, as, the general merger regime has no equivalent test.

Consultation Activities

The Turnover Regulations were published in a consultation document on 29 July 2004. The consultation document sought views on these regulations.

Copies of the consultation document were sent to each of the water and sewerage undertakings, to selected firms of solicitors specialising in competition law, the CBI and WaterVoice. The consultation document was also available on the DTI website.

Officials offered meetings to all those sent copies of the consultation document. However, no recipients took up the offer to meet to discuss the draft SI.

Responses to Consultation

The deadline for responses was 28 October 2004. Ten responses were received: 8 were received from businesses or representatives of them, one from a consumer organisation, and one from a regulator. The government would like to thank respondents for the useful feedback received.

The responses, except those made in confidence, are available in the DTI Library and can be accessed on request by contacting the Information and Library Services in the DTI on 020 7215 6226. The majority of responses were submitted online. A list of those respondents who were willing to have their names and responses disclosed can be found at Annex A.

Understanding this document

This report follows the order of the July consultation document. It gives an account of the views expressed in relation to each of the questions asked by the Government. The total number of respondents on each issue is given before the main points are summarised. Not every respondent is cited in each case, not least because some submissions repeated views already expressed by others. The Government's conclusions are set out in bold print at the end of each section.

Several respondents offered views on issues that were outside the scope of the consultation. This document contains a summary of these additional views, although discussion of them is generally more limited.

The overall response to the consultation

The overall tone of responses to the consultation was positive. Most respondents were content with the proposed approach to the calculation of turnover, which is consistent with the approach used in the Enterprise Act Turnover Order. There was some concern about some of the proposals, in particular regarding the

inclusion in the calculation of turnover of a water enterprise over which the target company holds only material influence (rather than control) (question 5 in the consultation). The concerns here centred on whether it was sufficiently clear what would constitute material influence, and indeed whether holding less than a controlling interest was sufficient to effectively influence policy.

A few comments were made about issues that are outside the scope of the consultation. The main point raised, by several respondents, was a belief that the turnover threshold for a mandatory reference to the Competition Commission was too low.

These issues, along with the other comments raised in the consultation, are summarised and discussed under the questions asked in the consultation document (matters outside the scope of the consultation are under the heading “Other Issues”).

Responses to the consultation and the government’s reply

Basis for calculation

Question 1: Do you agree that the turnover should be calculated based upon the sale of products and the provision of services made by the appointed business (as defined in the draft Regulations attached), as set out in paragraph 3 of the Schedule to the draft order?

Nine respondents commented on this question. All agreed that the proposed approach was sensible or acceptable. One commented that the terminology “sale of products and the provision of services” is not particularly suited to the water industry, but understood that the terminology had been chosen to ensure consistency with the Enterprise Act Turnover Order.

The Government will proceed on this basis.

Modification of turnover to take account of significant recent transactions

Question 2: Do you agree that, as in the general mergers turnover legislation, the OFT should have discretion to decide whether or not to take account, in their calculation of turnover, of significant transactions or events which have occurred since the end of the relevant business year which may affect the turnover of the business?

Nine respondents commented on this question. All nine agreed with the principle. One correctly noted that this was primarily a test of whether a company that would otherwise fall outside the regime comes inside it as a result of a significant post-year end transaction. One respondent agreed in principle that the OFT should have discretion to include transactions or events post the end of the relevant business year in the calculation of turnover, but suggested that some clarification is required in determining the scale of the circumstance(s) that could be deemed to constitute “significant transactions or events”. Another

accepted the need for a flexible approach. Another expected that OFT would informally consult Ofwat before deciding whether to use this discretionary power.

The OFT's document "[Guidance note on the calculation of turnover for the purposes of Part 3 of the Enterprise Act 2002](#)" (July 2003) sets out, at paragraph 1.10, that the OFT will look at acquisitions or disposals that have a significant continuing effect on turnover (whether positive or negative). The note sets out that OFT would expect to exercise this discretionary power only where it would be important for purposes of ascertaining jurisdiction or the appropriate fee level. Furthermore, parties contemplating a merger can seek informal advice from the OFT on proposed mergers which are not yet in the public domain (see chapter 3 of OFT's document "Mergers: Procedural Guidance" (May 2003) for further details).

The government will proceed on the basis proposed in the Consultation Document.

Calculation of turnover for the purposes of section 33(1)(b) of the Water Industry Act 1991

Question 3: Do you agree that paragraphs 4 – 9 of the Schedule to the draft Regulations should only apply when determining the turnover of a water enterprise to see whether the test in section 33(1)(a) of the WIA91 is met?

Nine respondents commented on this question. Eight agreed with the proposal. One summarised its understanding of this as being that these paragraphs would only apply to the assessment of turnover of the entity being sold off and not that of the acquirer.

One respondent did not agree that the concepts of control (as expounded in paragraphs 5-7 of the Schedule) should only apply to the test at s33(1)(a) and not to s33(1)(b). They argued that these concepts of control are relevant in determining whether a water enterprise ‘already belong[s] to the person making the take over’ and therefore only paragraph 4 of the Schedule should not apply to s33(1)(b).

The government considers that the paragraphs are relevant only to determine the enterprises to which paragraphs (4) (8) and (9) of the Schedule apply and in turn that these calculations are relevant only to determine the water enterprises whose turnover are to be aggregated for the purposes of section 33(2) of the WIA91. No such aggregation occurs when calculating turnover for the purposes of section 33(1)(b) of the WIA91; each water enterprise is treated as being a separate enterprise.

In determining which enterprises should be looked at for the purposes of section 33(1)(b), to see if their turnover exceeds the qualifying threshold, the concepts of control set out in section 26 of the Enterprise Act are relevant.

Combination of the turnover of linked water enterprises

Question 4: Do you agree that the turnover of linked water enterprises should be aggregated for purposes of calculating turnover?

Eight respondents commented specifically on the question of linking transactions. All agreed that this was a reasonable approach, though one respondent (the regulator) felt that the use of the term “linked enterprises” in the consultation document was not helpful as it did not appear in the legislative provisions, nor was it defined in the consultation document.

The Government will proceed on the basis proposed in the Consultation Document.

Addition of turnover of water enterprises over which only material influence is held

Question 5: Do you agree that the turnover of a water enterprise over which material influence is held should be taken fully into account when calculating the total turnover for the purposes of section 33(1)(a) of the WIA91?

Nine respondents commented on this question. Five agreed with the approach. Three others commented on the term “material influence”: one considered the approach reasonable but thought that further clarity was needed as to what constituted material influence; the other two respondents were concerned about the vagueness of the term. One believed that it could be argued to include situations where a very minor interest is held, whereas in practice a controlling interest is necessary to achieve effective influence over the policies and performance of a water enterprise. The other had concerns over the clarity of the definition of “materially influence”. Whereas ownership and financial control have a clear and common understanding, their view was that “material influence” is more subjective and open to interpretation.

The ninth respondent agreed with the proposition that the turnover of a water enterprise over which material influence is held should be taken into account when calculating turnover for the purposes of s33(1)(a) WIA91, but believed that the concept of material influence is also relevant in determining whether a water enterprise already ‘belongs’ to the person making the take over at s33(1)(b).

Paragraph 2.10 of OFT’s “Mergers: substantive assessment guide” sets out standard principles for determining material influence. Moreover, under the Enterprise Act the reasoning behind the decisions on all qualifying mergers are published on the OFT website. Similarly, the Competition Commission publishes details of all cases on which it reports. These decisions deal with jurisdiction as well as competition analysis and offer an additional source of information on the types of cases where material influence is held. Together, these sources provide substantial clarity on the meaning of material influence.

The Government accepts that there will always be some cases that involve a fine judgement as to whether material influence exists or not.

But in light of the OFT guidance, the information on past cases on the OFT and CC websites, and the fact that this provision has been successfully used in the Enterprise Act general merger provisions for 18 months (and was also a feature of the Fair Trading Act 1973 mergers regime) it considers that there is sufficient guidance and expertise available on the question of what constitutes material influence for this to be used in the calculation of water turnover.

The Government considers that it would be ultra vires for the Turnover Regulations to determine which water enterprise already belonging to the person making the turnover for the purposes of section 33(1)(b) of the WIA91.

Sales or services between water enterprises under common control

Question 6: do you agree that the calculation of applicable turnover should take account of goods or services provided to water enterprises under common control or ownership with the water enterprise to be divested?

Nine respondents commented on this question. Seven agreed, one specifically noting that they agreed as it achieved consistency with the procedures adopted in the general merger regime.

One respondent was not clear on the interpretation of Paragraph 9 of the draft schedule. They noted that it states that the calculation of applicable turnover should take account of goods and services provided to water enterprises under common control or ownership with the water enterprise to be divested. The example given is where the enterprise being sold off provided call centre facilities for the whole group. They considered that the calculation of turnover should be on the principle of turnover which the entity could obtain in its own right and not that which is obtained as a result of being part of a group. Using the example given if, following divestment, the entity will no longer provide call centre services then the turnover previously received from such services should not be considered in the OFT calculation. They did not consider that the proposals in Paragraph 9 agreed with this principle

The other respondent focussed on the question of whether this calculation should only be carried out when looking at the turnover of a water enterprise being taken over (the test in s33(1)(a) of the revised WIA91 provisions), but not when looking at the individual turnovers of water enterprises belonging to the acquirer (the test in s33(1)(b) of the revised WIA91 provisions). For the reasons stated above (see the response to question 3) the Government does not consider that the sections should be so extended.

On the interpretation of paragraph 9, the intention of the regime is that companies whose turnover, at the time the case is being considered, exceeds the threshold should be subject to the regime. The

government does not consider it appropriate to take account of future plans, such as whether some of that turnover will continue to be generated, as it does not accord with the principle of looking at the turnover at the time of the investigation. So if, as in the example quoted, the call centre business qualified as appointed business, a turnover would be attributed to it in accordance with paragraph 9 of the schedule. If the call centre business were not appointed business then the turnover calculation would take no account of it.

On the question of whether the calculation should also be made when looking at the turnover of companies already owned by the acquiring company for purposes of section 33(1)(b), only paragraphs 2 and 3 of the schedule to the Turnover Regulations apply, which means that the full applicable turnover is used. This covers the turnover of the enterprise providing services to businesses or consumers - which will include services provided to water enterprises also owned by the parent company (as they are treated as separate enterprises for the purposes of section 33(1)(b)). So in all cases the full applicable turnover will be taken account of."

The Government will proceed on the basis proposed in the Consultation Document.

Other Issues

Threshold for mandatory reference

Three respondents commented on the turnover threshold level of £10 million. One respondent questioned whether the threshold was set at the right level and is in customers' best interests. It suggested that in practice all mergers between existing water enterprises will require mandatory reference to Competition Commission and therefore the reference requirements act as a barrier to the development of proposals for consolidation. The respondent made reference to the report for DEFRA and Ofwat "[Structure of the water industry in England: does it remain fit for purpose?](#)" (November 2003), by John Smith and Duncan Hannan, which highlighted this point and recommended that the Secretary of State should review the threshold to allow some consolidation in the water industry. The respondent noted that the level of the threshold needs to be chosen with care so that it does not simply create 'open season' on the smaller water only companies. Instead, it suggested that the threshold should be set so that it is not seen by likely parties as a severe impediment to potential mergers.

A second respondent noted that there is a case for a much higher threshold and commented that it was curious that government had not consulted on this (as the Secretary of State can change the threshold using section 33(7) of revised WIA 91 once it comes into force.

The third respondent suggested the threshold will limit potential purchasers to private equity firms, financial institutions or (less likely) overseas trade buyers,

rather than those with UK water industry experience, and questioned whether such a policy is in the best long term interest of water consumers.

The Enterprise Act introduced changes to the special water merger regime which brought the water merger regime more into line with the general mergers regime put in place by the Enterprise Act. The purpose of the legislation was not to alter materially the purpose or scope of the special water merger provisions in the WIA91. It is not, therefore, appropriate to consider changing the qualifying threshold when bringing into force legislation Parliament accepted was not intended to make material changes to the regime.

Only catch companies caught under old regime

One respondent noted that the expectation in moving from an asset value threshold to a turnover threshold is that the same number of water enterprises will be 'caught' by the new legislation. They proposed that it would be helpful if this were confirmed, and that the OFT were to be specifically directed to have regard to this requirement, perhaps in the schedule to the instrument.

As noted in the consultation document, the threshold put in place in the WIA91 is expected to catch the same number of water enterprises as are caught by the current assets threshold test. The government does not consider there is a need to amend the WIA91 so that the OFT should have regard not only to the turnover threshold but also to whether a merger would have been caught under the old assets threshold, and lacks the vires to do so in the Turnover Regulations.

Are retail / retail and supply licensees caught by regime?

'Water enterprises' are water and sewerage undertakers. This excludes the type of water enterprise arising from the Water Act 2003, that is new retail or combined retail and supply licensees. Is it the intention that these types of enterprise remain outside the provisions?

Retail or combined retail and supply licensees are not "water enterprises" for the purposes of the merger provisions of the WIA 1991, and fall outside of these provisions.

Annex A: Respondents

<p><u>Bournemouth and West Hampshire Water plc:</u> Tony Cooke Managing Director Bournemouth and West Hampshire Water plc George Jessel House Francis Avenue Bournemouth BH11 8NB</p>	<p><u>Head of Regulation at South West Water:</u> Keith Richards Head of Regulation South West Water By email</p>
<p><u>Mid Kent Water:</u> Richard Allison Head of Economic Regulation Mid Kent Water plc Snodland Kent ME6 5AH</p>	<p><u>Northumbrian Water:</u> Ceri Jones Regulation and Compliance Director Northumbrian Water Abbey Road Pity Me Durham DH1 5FJ</p>
<p><u>Ofwat:</u> Lindsay Draffan Senior Legal Assistant Ofwat Centre City Tower 7 Hill Street Birmingham B5 4UA</p>	<p><u>South East Water:</u> Chris Pleass Director of Finance and Investment South East Water 1-3 Church Road Haywards Heath West Sussex RH16 3NY</p>
<p><u>Thames Water Utilities Ltd:</u> Jerry Cresswell Head of Economic Regulation Thames Water Utilities Ltd Clearwater Court Vastern Road Reading RG1 8DB</p>	<p><u>WaterVoice:</u> WaterVoice, Centre City Tower, 7 Hill Street, Birmingham B5 4UA</p>

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