

## Summary

1. On 16 November 2006 the Office of Fair Trading (OFT) referred the acquisition by Hastings Diversified Utilities Fund (HDUF) and Utilities Trust of Australia (UTA) of South East Water (SEW) to the Competition Commission (CC) for investigation and report. HDUF and UTA are also the owners of Mid Kent Water (MKW). The reference was made under section 32(b) of the Water Industry Act 1991 (WIA). This is the first water merger inquiry to be referred to the CC under the new water merger provisions of the WIA. We are required to publish our final report by 02 May 2007.
2. The acquisition of SEW by HDUF and UTA was announced on 2 October 2006. HDUF and UTA already owned MKW. Given that SEW and MKW are under common ownership, we found that a water merger has taken place. We therefore had to decide whether the merger has prejudiced, or may be expected to prejudice, the ability of the Water Services Regulation Authority (Ofwat), in carrying out its functions by virtue of the WIA, to make comparisons between different water enterprises.
3. MKW is a Water only Company (WoC) that serves a population of around 590,000 in Kent and a small part of East Sussex. The population that it serves is expected to grow significantly. In 2005/6, MKW was the fourth largest WoC by Regulatory Capital Value (RCV) and the sixth largest by turnover.
4. SEW is a WoC that serves a population of around 1.4 million and has about 604,000 customers. Its total supply area is split into two distinct, non-contiguous areas: the northern region, which includes parts of Berkshire, Hampshire, Surrey and West Sussex, and the southern region, which includes parts of Kent, East Sussex and West Sussex. The southern region shares a boundary with MKW. SEW is the second largest WoC by turnover and by RCV.

5. Subject to the outcome of the present investigation, HDUF and UTA intend to merge MKW and SEW into one company holding a single licence under the WIA. Hastings told us that the integration of SEW and MKW would give rise to benefits which could not be realized absent the integration. It said that these benefits were threefold: cost savings; the alignment of efficient practices; and better management of water resources.
6. Following a number of mergers, the water industry in England and Wales now includes ten Water and Sewerage Companies (WaSCs) and 12<sup>1</sup> WoCs. Ofwat is the economic regulator of the water industry. It succeeded the Director General of Water Services on 1 April 2006.
7. Within its area of operation each company is a virtual monopoly. Domestic customers have no choice of supplier. There is some scope for competition for large users through inset appointments, water supply licensing (WSL), cross border supplies and self-laying of pipes, but competition in the industry is very limited.
8. In the absence of market competition, a system of comparative competition aims to simulate rivalry in a competitive market and help Ofwat to ensure that the regulated companies have incentives to improve efficiency and levels of service to consumers. On the basis of comparisons between companies, Ofwat assesses each company's performance and sets price controls specific to each company. The most recent price caps were set in 2004 for the period from 2005 to 2010 (PR04).
9. Through comparative analysis, Ofwat seeks to identify the most efficient company in each cost area and the position of the other companies relative to the most efficient company. Ofwat uses econometric and cost base approaches to determine, as

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<sup>1</sup>Excluding Cholderton Water and Albion Water, which each serve only a small number of customers.

appropriate, the most efficient company in relation to each of operational expenditure, capital maintenance expenditure and capital enhancement expenditure.

10. In addition to the comparisons used in price reviews, Ofwat also uses data provided by water companies to undertake a number of other comparisons, some of which rank companies on the basis of a quantitative score. In making these comparisons Ofwat uses league tables and other qualitative comparisons which draw attention to particular companies' best practice.
11. We identified four different ways in which the merger might adversely impact upon Ofwat's ability to make comparisons between water enterprises in carrying out its functions under the WIA. These were as follows:
  - the merger may remove a potential benchmark company from Ofwat's econometric models;
  - the merger may reduce the precision of the econometric models from which Ofwat estimates technical efficiency targets;
  - the merger may adversely affect Ofwat's ability to make cost base comparisons and challenge cost base estimates; and
  - the merger may adversely affect Ofwat's ability to make other, qualitative comparisons between companies.
12. Hastings told us that, should the merger be allowed to proceed, it would merge the operations of MKW and SEW so that the two existing companies operated as a single company under one licence. In discussing each of the possible adverse impacts, we compare the effects of the merger to the counterfactual situation which we take to be the industry with the existing number of comparators, including MKW and SEW operating separately.

13. Given the long-term nature and relative stability of the water industry, we considered whether the merger may adversely affect Ofwat's ability to make comparisons at the next price review in 2009 (for the period 2010 to 2015: PR09) and at the following price review in 2014 (for the period 2015 to 2020: PR14). We were unable to predict the future with a sufficient degree of reliability after PR14.
14. We considered the possible adverse impact on the benchmark in Ofwat's econometric models and looked specifically at the chances of MKW, SEW and the merged company forming a benchmark. We reached a provisional view that MKW was not likely to form the benchmark in the next two price review periods for either operating expenditure or capital maintenance expenditure. On balance, we did not consider that we had sufficient evidence to form an expectation that the merged company's performance would be worse than that of SEW. We considered it equally likely that the merged company would be more efficient, or at least as efficient, as SEW. We therefore provisionally concluded that it was not likely that there would be an adverse impact arising from the loss of a potential benchmark company as a result of this merger.
15. We looked at the possible impact of the merger on the precision of Ofwat's econometric models, and hence its ability to set appropriate efficiency catch-up targets. We found that Ofwat's models were sufficiently robust to be of use with both 22 and 21 comparators. We provisionally concluded that the merger would be likely to lead to an adverse impact on the comparisons Ofwat makes using its operating expenditure econometric models. We expected that the precision of these models would reduce which would be likely to lead to higher price caps being set for companies in England and Wales than would otherwise be the case. The impact of the merger on the precision of the capital maintenance expenditure econometric models was less clear. However, on balance, we considered it more likely than not

that the precision of the capital maintenance models would be adversely impacted by the merger, albeit that the financial impact was likely to be lower.

16. We looked at whether the merger might be expected adversely to affect Ofwat's ability to make cost base comparisons and challenge cost base estimates. We first considered whether the merger may remove a potential benchmark. We found it unlikely that MKW's standard costs would be selected as a benchmark. We found that there was potential for some of SEW's standard costs to be selected as benchmarks, but that it was more likely that larger companies, and hence the merged company, would submit benchmark standard cost estimates. We therefore provisionally found that it was not likely that the merger would remove a potential benchmark comparator for standard cost comparisons.
17. We also considered whether the merger may be expected to reduce the dispersion of companies' cost base estimates, removing an innovative or best practice solution that could be shared amongst other companies; valuable data that might allow Ofwat to challenge costs more successfully overall than it could with the remaining data it had available; or average data that helps Ofwat to identify valuable data, especially in categories of standard costs with few comparators.
18. For the most part we thought it unlikely that the merger would reduce Ofwat's ability to identify innovative or best practice solutions, given the continuing availability of a large number of solutions, including those from larger companies. However, we found that there is likely to be a small impact arising from the reduction in the number of comparators for some standard costs where there are already relatively few comparators.

19. We looked at whether the merger might be expected adversely to affect Ofwat's ability to make qualitative comparisons. We looked at three main ways in which Ofwat may make comparisons on the basis of qualitative data: publishing league tables; using information received from one company to challenge other companies' proposed approaches to particular issues; and publicising both good and bad practice.
20. We found that Ofwat uses a variety of indicators, many of which allow Ofwat to gain valuable information, to challenge other companies, and to improve water companies' efficiency. However, for the most part, given the availability of information on 20 other companies, it was not clear to us that MKW or SEW would provide information of significant additional value for Ofwat's future qualitative comparisons, and that Ofwat would therefore lose valuable information as a result of the merger.
21. We provisionally concluded, however, that, given the variety of comparisons undertaken, and the qualitative nature of such comparisons, the merger was likely to lead to an adverse impact on Ofwat's ability to make qualitative comparisons, but that the scale of any such adverse impact was likely to be small.
22. We were not able to put a financial value on these adverse impacts in total. However, we estimated that the adverse impact arising from the decrease in precision of Ofwat's operating expenditure econometric models as a result of the merger might be of the order of £5 million for one review period.
23. We looked at whether there were alternative approaches available to Ofwat which might mean that, even with the loss of a comparator following the merger, there would be no prejudice to Ofwat's ability to make comparisons.

24. We found there to be scope for exploring the use of both sub-company data and, in particular, panel data. There might also be scope to ensure that Ofwat made the maximum use of the available data from other sources (eg other countries or industries), and to use alternative techniques (such as stochastic frontier analysis (SFA) and data envelopment analysis (DEA)) to validate the results of Ofwat's existing econometric models where possible.
  
25. We found that it was not possible, in the context of a merger inquiry, for us to reach a definitive view as to the methodologies Ofwat should adopt for PR09 and for the future. We noted that Ofwat is actively exploring its methodologies for PR09, and that it was doing so independently of the merger. We were not persuaded that our views on the impact of a loss of a comparator as a result of this merger would differ significantly if Ofwat were to use any of the alternatives identified. We provisionally concluded that there was likely to be some adverse impact as a result of the merger on Ofwat's ability to make comparisons between water companies.
  
26. We provisionally concluded that the merger may be expected to prejudice Ofwat's ability, in carrying out its functions by virtue of the WIA, to make comparisons between different water enterprises.