8 Views of third parties

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Introduction

8.1. A wide range of third parties was invited to make representation to the CC. We contacted 233 parties including customer representative bodies, trade unions, economists and economic consultants, MPs, local authorities, regulatory bodies, WoCs, WaSCs, large customers, environmental conservation groups and utility groups. We received 32 replies. An advertisement was also placed in the press in response to which three replies were received. Oral hearings were held with Centrica Plc (Centrica), Indepen Consulting Ltd (Indepen), NERA, Severn Trent, South Staffs Water, Thames Water, UUW and WaterVoice Southern. Their views and the written evidence we received are summarized in this chapter. Some of the responses we received addressed issues outside the remit of the inquiry (see paragraphs 3.3 to 3.8 for the explanation of the constraints on the scope of the inquiry); these submissions have not been included in the chapter.

Trade unions

Transport and General Workers' Union

8.2. The Transport and General Workers' Union (TGWU) is the UK's biggest trade union with over 900,000 members.

8.3. TGWU expressed concern that VE could dominate the waste and water markets in southern England and highlighted the strength of the group's present position through its ownership of WoCs and its interests in waste companies such as Onyx. The potential for this dominance was enhanced by the operation of regional clubs, whereby a VE subsidiary was considered before any other subcontractor when work was tendered by a group company.

8.4. TGWU stated that, while at present Southern carried out its own operations work, VE might subcontract this work to one of its other subsidiaries leading to a loss of jobs within Southern. It questioned whether this type of interrelationship was in the interests of customers.

8.5. TGWU opposed any remedy that required Southern to divest its operations in Hampshire and the Isle of Wight.

Customer representative bodies

WaterVoice Central

8.6. WaterVoice Central is one of the ten regional WaterVoice (formerly Customer Service) Committees established by the DGWS under section 28 of the 1991 Act. It represents the interests of customers of Severn Trent Water and South Staffs Water.

8.7. WaterVoice Central stated that comparative competition was successful in protecting customers. It had contained prices while ensuring improvements in the service provided.

8.8. WaterVoice Central was opposed to the suggested remedy whereby VWUK would be required to sell its stake in South Staffs Group to counter a detriment arising from the merger. It argued that this remedy would leave South Staffs Group exposed to possible takeover, which could result in the loss of South Staffs Water as a comparator.

WaterVoice Southern

8.9. WaterVoice Southern represents the interests of customers of F&D, Mid Kent Water, Portsmouth Water, South East Water and Southern.

8.10. WaterVoice Southern emphasized that since privatization water customers had experienced improvements in the quality, service and price of water, which WaterVoice Southern attributed to the effectiveness of the regulatory regime. WaterVoice Southern added, however, that the structure of the industry was artificial, insulating licence holders from competition, and in the long term this could result in the ossification of the industry. WaterVoice Southern said that section 34 of the 1991 Act could, in some instances, operate against consumer interests when applied to prevent a water/water merger which would, through synergistic benefits, have benefited customers. WaterVoice Southern acknowledged that section 34 also served to prevent mergers occurring which would reduce the scope of DGWS's power to make comparisons and required that, if such prejudice occurred, the CC must downgrade all other public interest factors to a subsidiary status. WaterVoice Southern questioned, however, whether it was appropriate for the dilution of the purity of a comparator, through a change of ownership, to be treated as the loss of a comparator.

8.11. WaterVoice Southern recognized the concerns of the DGWS that the merger would reduce the number of comparators in the water industry by one, but felt that the regulatory regime was and should continue to be dynamic in the methods employed. WaterVoice Southern observed that Southern had been used as a benchmark company when it was a subsidiary of Scottish Power. In this instance the DGWS had viewed the ring-fencing arrangements as effective enough to guarantee the independence of Southern.

8.12. WaterVoice Southern stated that there was no obvious reason why Southern could not continue to be used as a benchmark comparator after the merger. It acknowledged that it did not have sufficient information to judge whether the loss of Southern's independence would substantially prejudice the DGWS's performance of his duty. WaterVoice Southern hypothesized, however, that it would be possible to separate out, in terms of finance and performance, the results of two of VWUK's other WoCs, Three Valleys and Tendring Hundred, as they were geographically discrete. WaterVoice Southern recognized the need for the DGWS to monitor transfer pricing, but argued that this did not prevent him from insisting that the companies remain separate for regulatory accounts and asset register purposes, as occurred at present with the existing VWUK subsidiaries. WaterVoice Southern viewed the loss of F&D as a comparator, through its likely absorption into Southern, as insignificant: F&D was too small a company to be used as a benchmark, in addition to which it was already owned by the parties to the merger.

8.13. WaterVoice Southern cited the EC Decision of 1995, which specified that the minimum number of comparators should not be higher than necessary for effective regulation. WaterVoice Southern stated that it had seen no evidence about what was the minimum number of comparators. It argued, however, that the ten WaSCs seemed to provide sufficient comparative data in the sewerage sector.

8.14. WaterVoice Southern observed that the acquisition of Southern by VWUK would result in no change in sewerage comparators. Indeed the merger would make available to Southern information about the VE group's sewerage activities worldwide which would, WaterVoice Southern argued, enhance Southern's value as a sewerage comparator.

8.15. WaterVoice Southern suggested that, should the merger be considered prejudicial, the DGWS could require the water companies to provide disaggregated accounting information, as he did at present with the sewerage companies. WaterVoice Southern argued this might be practicable as Southern's water supply business was already spread over seven geographically discrete areas. The disaggregated information would enable the DGWS to conduct a more detailed scrutiny of the companies, thus mitigating any prejudice caused by the merger.

8.16. The value of Southern as a comparator for aspects other than cost, for example water quality, customer services etc, would not be diminished by the merger.

8.17. WaterVoice Southern recognized that there was typically convergence between companies within a group, but questioned whether this would necessarily be to the detriment of consumers, as the VWUK companies uniformly excelled in customer service and capital maintenance. It did not expect the minority investors to influence policy.

8.18. WaterVoice Southern stated that the interests of customers would be best served if the merger went ahead and F&D became integrated with Southern, provided that the ring fencing protected the merged company from the financial problems of Vivendi Universal. WaterVoice Southern thought that economies of scale and efficiency improvements could be expected to occur following F&D's integration into Southern. WaterVoice Southern highlighted the problem posed for F&D by the shortage of water resources, leaving it reliant on the purchase of water in bulk from other sources, a high-cost activity.

F&D, in common with other small WoCs, operated with high unit costs and encountered difficulties securing supplies. WaterVoice Southern viewed this as part of a wider problem throughout Kent and East Sussex, where companies currently struggled to meet peak demand. The merger offered the possibility of providing a 'ring main' around the perimeter of Kent, which would help to address the supply problem.

8.19. WaterVoice Southern believed that in the long term water companies in south-east England would come under greater pressure from the EA, the European Commission and the DWI to improve the standards of bathing and drinking water. Directives from these agencies would have cost implications for the companies which, unless countered with gains in efficiency and cost reductions, would be passed on to consumers through higher prices. WaterVoice Southern believed that such gains could only be achieved through further consolidation within the industry.

8.20. WaterVoice Southern addressed the possible remedies set out in the CC Statement of Issues. It recognized that divestment by VWUK of its holding in South Staffs Group was the obvious possibility. It argued against a remedy which would require Southern to hive down and divest a separate water company for Hampshire and the Isle of Wight. WaterVoice Southern believed that it was unlikely that such a company would remain independent and was concerned that the costs associated with the separation would be passed on to customers. Moreover, there would be adverse cost implications for the rest of Southern's customers. Since Southern was an efficient company, it seemed capricious to break it up for the sake of some economic purity. In addition, WaterVoice Southern did not believe that a forced reduction of Southern's prices, which already reflected performance at the frontier of efficiency, would benefit the public other than in the short term. It argued that, if the CC wanted to attach conditions to the merger, the conditions should be addressed to bringing about improvements in Southern's capital maintenance performance.

Consultants and economists

Indepen Consulting Ltd

8.21. Indepen is a management consultancy specializing in regulation and strategy with particular expertise in the utility sector.

8.22. Indepen believed that the operation of the special merger regime in water was against the public interest. The current controls had resulted in the ossification of the industry and, by insulating companies from the threat of takeovers, had removed a key incentive for management to improve efficiency. The absence of rationalization opportunities had forced management to consider other options such as increased gearing, which would lead to equity leaving the sector.

8.23. Indepen estimated, on the basis of savings projected in previous merger proposals, that if mergers in the water industry reduced the number of companies by half, the total savings in present value terms would be approximately £6 billion. Subsequently, Indepen submitted a published paper *Water merger policy: time for review.*[1] The paper estimated that permanent price reductions of between 6 and 12 per cent were possible for different water merger combinations (assuming that the savings from economies of scale and best practice were passed on to the target company's customers).

8.24. Indepen argued that the current structure of the industry prevented efficiency improvements, particularly in Southern's area. A single company ran the sewerage services in the area whereas six different companies provided the water services. Moreover, Southern's own water supply customers were in a number of geographically separate areas. Indepen believed that rationalization of this historical structure could only occur through mergers.

8.25. Indepen believed that Ofwat, in previous merger referrals, had overstated the value of the loss of a comparator. Indepen argued that Ofwat had calculated the loss based on its existing method of comparison and had not taken account of the different forms of comparison available to regulators. Moreover, to compensate for any detriment occurring from the loss of comparators, wider benchmarking and comparisons, including international, could be used to restore the effectiveness of the comparative approach.

[1] *Water merger policy: time for review*, Indepen Consulting, in association with Accenture, July 2002.

NERA

8.26. NERA is a firm of consulting economists operating worldwide.

8.27. NERA noted that the situation in the water industry was now different to that immediately after privatization in that:

(a) there was more data available for the DGWS's regulatory purposes;

(b) companies were likely to have already made the easy gains in efficiency; and

(c) companies' financial cushions were now much less than they had been.

8.28. NERA submitted that there was definitely a case for managers to use comparisons between regulated businesses to drive efficiencies. The more contentious issue was how the regulator used comparators. NERA advised caution when comparisons were made by taking data from one place and applying it to another. Subjectivity on the regulator's part could undercut companies' ability to run high-powered performance regimes.

8.29. NERA considered that Ofwat's methods needed to be more transparent. The DGWS should aim to secure agreement on objective methods for setting the elements of K in order to improve the incentive power of the regime. This would assist him to avoid accusations of subjectivity and to provide incentives, allowing the regulated companies, and hence customers, to gain directly from the efficiencies made, as well as from a reduction in risk as perceived by the capital markets and a lower cost of capital.

8.30. NERA submitted that Ofwat's models for capital maintenance and opex were problematic due to the inconsistency of cost allocation and other data issues. Ofwat claimed that it had undertaken checks but had not published anything about this. There appeared to be a negative correlation between companies' scores on opex and capex.

8.31. NERA noted that the power of Ofwat's models declined rapidly as the number of data sets dropped below 20. One credible response would be the use of panel data: NERA had undertaken some studies which had proven robust and appeared to be superior to Ofwat's use of 'snapshot' data (see paragraph 5.24). Ofwat's reservation about using panel data appeared to be that the cost function was not stable over time. Although NERA could understand this reservation, it submitted that Ofwat had no empirical evidence to support the concern. NERA was doubtful that the cost function was moving so fast in the water sector that panels of at least a few years' data were not an improvement on the one-year snapshot.

8.32. NERA submitted that a further advantage of using multi-year panels was that it forced the regulator to consider the importance of input price movements as opposed to productivity change. It was important to consider these two factors separately because of the volatility of input price changes. NERA concluded that it saw a lot of merit in the use of panel data.

8.33. NERA had reservations about Ofwat's use of sub-company level data for the sewerage industry. Ofwat did not appear to do much to check the effect of common ownership on the sub-company data. There were also problems relating to cost allocation. One possibly credible alternative approach would be to break down water and sewerage information into geographical zones and put a variable into the model to allow for the effect of common ownership.

8.34. NERA considered that the use of international comparisons was fraught with difficulty for a number of reasons, including differences in effective prices, in the working environment, in regulations and in culture.

8.35. On the issue of independence, NERA said the loss of a company's independence was less serious for the comparative regime than the complete disappearance of a comparator. Common ownership did not mean that a company's data sets were of no informational value, and the effect of common ownership on companies' performance should be tested for in the modelling. It would not be difficult to set up a modelling approach that tested for the value of the loss of information derived from the comparator, for example by introducing a company control variable as an explanatory factor into the snapshot model.

8.36. NERA submitted that experience had supported the expectation that takeovers increased efficiency. Therefore deterrence of mergers had serious implications. NERA noted that there needed to be a balance between achieving the benefits of mergers and preserving Ofwat's ability to make comparisons.

8.37. NERA noted that, on average, about 65 per cent of water companies' total spend was subject to competitive procurement (because of the size of their capital programmes). The growth in competitive procurement and contracting out reduced the requirement for modelling to 'second-guess' the correct rate of improvement in efficiency. High levels of gearing also put more pressure on managements to maximize efficiency.

8.38. NERA submitted that it was not possible for Ofwat to put a single figure on the value of a comparator, as Ofgem had done, because of the great disparity in the range of companies in the water industry. Ofgem had had less need than Ofwat to undertake sophisticated modelling as the electricity distribution companies were more similar than water companies, and the industry was more homogeneous than water.

Professor Colin Robinson

8.39. Prof Robinson is the Professor of Economics at the University of Surrey. He submitted his views on the use of comparative competition for the water industry. He believed that circumstances in the water industry were not propitious for comparative competition to work effectively and had doubts about the details of Ofwat's regime.

8.40. Prof Robinson considered that markets worked best for the benefit of consumers when there was competition in both the product market and the market for corporate control. Product competition did not entail perfect competition but rather circumstances where the market was competitive due to ease of entry. He stated that, as well as providing improvements in productive and allocative efficiency, these competitive forces provided a powerful incentive to innovate, as entrepreneurs in competitive markets were constantly on the lookout for new ways of operating.

8.41. The underlying problem in the water industry was that neither of the basic elements of a market system was being permitted to operate. Product market competition existed only around the edges of the market for a few very large customers. The market for corporate control was severely constrained because of the fear that 'comparators' would be lost if water-to-water mergers occurred.

8.42. Prof Robinson advocated that product market competition should be introduced to the water industry. The absence of product market competition had made entry difficult, which in turn made takeovers more attractive. Takeovers had, however, been restricted as they detracted from the current regulatory regime. The absence of product market competition had eventually resulted in the lack of capital market competition.

8.43. He recommended a more positive attitude be taken towards mergers in the water industry as an initial step towards product market competition. He considered the takeover mechanism to be a key feature of a market system and thought it perverse to suppress it in circumstances where product market competition was also absent, which left customers entirely reliant on the regulator for protection.

Members of Parliament

Ann Widdecombe

8.44. The Right Honourable Ann Widdecombe is the MP for Maidstone and the Weald. She said that, having received our letter inviting comments on the merger, she had taken soundings with Southern and with a representative of VWUK. Ms Widdecombe said she was satisfied that VWUK could be seen as distinct from Vivendi Universal. She had had two major concerns: whether the acquisition would result in redundancies in her constituency; and the EA's worry over Southern's record on pollution. On the former, VWUK had answered her that it had every expectation that those presently employed by Southern would remain so. On the latter, she understood that VWUK had given an informal commitment to address the problems.

8.45. Ms Widdecombe recognized that VWUK appeared willing and able to make concessions in order to meet the concerns of Ofwat. On balance, she felt that the comparative regime would not be compromised by the merger.

Regulatory bodies

The Environment Agency

8.46. The EA is a non-departmental public agency established by the 1995 Environment Act. One of the agency's duties is to ensure the provision, conservation and proper use of water resources in England and Wales.

8.47. The EA stated that the merger could lead to the optimization of water resources in Kent, which were at present over-committed. It would provide the opportunity for links to be forged between Southern's operating areas of Medway, Thanet and Hastings on the one hand and F&D's area on the other, thus improving efficiency. Moreover, the merger could provide improved security of supply to F&D's customers in addition to supporting the development of F&D's metering policy which was designed to improve the management of water resources.

8.48. The EA expected the merged entity to renew its commitment to the maintenance of bulk supply and shared resource agreements; the reduction of leakages; the retention and development of key staff and expertise; the maintenance of sewerage and sewage disposal systems; the investment in operational controls to reduce pollution incidents; and the implementation of the National Environment Programme. The agency wished to see a reduction in the number of pollution incidents caused and a commitment to continuing improvement from the merged company. Should these commitments not be forthcoming the agency would have concerns about supporting the merger.

8.49. The EA told us that there were a number of environmental projects under way in Hampshire at present including aspects of the current National Environment Programme, consultation on catchment abstraction management strategies and preparation of the National Environment Programme for 2005 to 2010. In addition, the EA recognized that there was a potential for the forecast surplus of water resources in Hampshire to be transferred to areas of Sussex with water shortages. Should the CC recommend that a new water company be created for Hampshire, it would be vital that the timing of the divestment and any transitional arrangements ensured that the new company could deal with all of these important environmental matters without causing delay or uncertainty.

8.50. The EA stated that, should Hampshire Water be operated as a separate company, the boundary of such a company should include the Isle of Wight because of the pipeline that transferred water from South Hampshire to the island.

Ofgem

8.51. Ofgem told us that comparative regulation had played an important part in the regulation of both electricity distribution and water services.

8.52. Ofgem stated that the differences in performance between electricity distribution companies, after taking account of the differing demographic, topographic and technical conditions under which they operated, was a result of the different strategies employed by the management teams and the success of their implementation. During the 1999 price review Ofgem set targets according to the most efficient companies' performances, placing strong demands on the less efficient companies. Since this review, consolidation had occurred in the industry with the number of separately managed groups falling from twelve to eight, leading to a significant loss of diversity in managerial and strategic approach.

8.53. Ofgem explained that, while consolidation might be expected to bring down prices for customers as a result of the adoption of integrated management structures and rationalization and reduction of the workforce, the homogenization of management adversely affected Ofgem's ability to regulate price controls and quality standards effectively. Despite Ofgem's insistence that merged companies produce separate data sets, their usefulness for comparative purposes was diminished. Ofgem also stated that common policies between companies reduced the scope for innovation and that less pressure would therefore be brought to bear on the efficiency frontier. Increasingly, rivalry between independent management teams seeking to maximize outperformance of the regulatory settlement would diminish. These outcomes would undoubtedly be detrimental to the customer.

8.54. Ofgem submitted that one measure of the scale of the positive effects of the comparative regime was demonstrated by the difference between price cuts Ofgem had made for the distribution companies and for the two national monopolies, NGC and Transco, where no comparison was possible. The differences with respect to controllable operating expenditure were equivalent to a differential rate of annual productivity improvement of 1.3 per cent. Ofgem explained that, as part of its ongoing regulation of the sector, it had decided to seek to impose a reduction of allowed revenues for merged companies of £32 million over five years, a figure based on estimates derived from the 1.3 per cent difference in rates of efficiency improvement. Ofgem would also pass back the efficiency savings which arose from a merger as part of the price control process.

8.55. Ofgem noted that the electricity distribution companies had disagreed with the calculation of the tariff of £32 million, while others had argued that Ofgem's calculations underestimated the value of losing a comparator. There had been no significant dissent, however, from the view that the loss of managerial and strategic diversity would reduce the prospect of rivalry among licence holders and would lead to diminishing innovations in efficiency. Ofgem acknowledged that views on the extent of the detriment arising from the loss of a comparator could be affected by the identity of the specific comparative method being employed. There was no widespread agreement on the most appropriate method to value the detriment. Nevertheless, irrespective of the choice of methods, the overall effectiveness of regulation was irremediably impaired if the number of independent management teams vying to outperform each other was reduced.

Water-only companies

Bournemouth and West Hampshire Water Plc

8.56. Bournemouth and West Hampshire Water Plc (BWHW) is a WoC operating in parts of Dorset, Hampshire and Wiltshire. It provides drinking water to 430,000 people.

8.57. BWHW stated that the creation of a free-standing WoC in Hampshire would not provide a suitable substitute for the loss of Southern as a comparator. On its own, such a company would lack the critical mass necessary to be a material comparator. Moreover, at present there was no separate support infrastructure or other central services for the Hampshire part of Southern and to establish these would be expensive. BWHW said that small WoCs, including itself, were not ideal or particularly valuable comparators usually because of company-specific characteristics. BWHW argued that a better comparator of greater value to Ofwat could be created through the merger of a new Hampshire Water with one of the existing contiguous small WoCs. Existing corporate systems such as finance and billing could be stretched to cover the Hampshire Water area thus removing the need for the new company to develop its own support services. It therefore proposed that there should be no provision preventing companies with water interests in England and Wales from acquiring Hampshire Water.

South Staffordshire Water PLC

8.58. South Staffs Water is a wholly-owned subsidiary of South Staffs Group, in which General Utilities Holdings Ltd (a VWUK subsidiary company) has a 31.4 per cent shareholding.

8.59. South Staffs Water said Ofwat's regime of comparative competition had been very successful. South Staffs Water had reshaped its operations in the last few years under the pressure of Ofwat's efficiency targets, removing 20 per cent of controllable costs while producing even higher levels of service. The publication of league tables ranking water companies' performance was a spur to management action.

8.60. South Staffs Water believed it was possible to preserve the value of comparators in common ownership provided they were separately managed and reported on, and were subject to Ofwat's ring-fencing conditions. It regarded Three Valleys, for example, as a valid comparator for South Staffs Water's own operations.

8.61. Despite the general effectiveness of the regulatory regime, there were problems arising from the separate assessments of opex, capex and return on capital. These led to ill-founded rankings of companies in Ofwat's league tables and created perverse incentives for management. Moreover, Ofwat placed too much emphasis on identifying statistical relationships in its models at the expense of managerial good sense. Its approach was too 'top-down'.

8.62. South Staffs Water argued that it would not be in the interests of customers for mergers between WoCs and WaSCs to become the norm. WoCs such as South Staffs Water offered competitive prices and customer service levels equal to or exceeding those provided by WaSCs. There were economies of scale in water services but they were not large and were capable of being offset by the greater flexibility open to small companies.

8.63. South Staffs Water said VWUK's shareholding in South Staffs Group was big enough to enable VWUK to exercise influence, for example by putting a director on the board. In practice, VWUK had been very 'hands off' and the shareholding had had no effect on South Staffs Water's operations. There had been only one strategic decision on which South Staffs Group had consulted VWUK as a major shareholder, concerning the takeover of another company (see paragraph 3.68).

8.64. South Staffs Water stated that the merger would lead to the loss of independence of a large water company, which it viewed as the most valuable type of comparator. The merger would thus serve to limit the statistical robustness of Ofwat's comparative regime.

8.65. South Staffs Water advocated the application of sufficient ring-fencing arrangements to ensure that the existing comparators, and in particular Three Valleys and Southern, could be regarded as stand-alone water companies available as separate comparators in Ofwat studies. On this basis the effect of the merger would be minimal. It was not VWUK's way to impose its own views on managers at South Staffs Water and it might be reasonable to assume the same would apply to Southern if the acquisition went ahead. South Staffs Water would not contest the validity, under VWUK ownership, of Southern as a benchmark comparator in Ofwat's price-setting process.

8.66. South Staffs Water agreed, however, that if the CC found that the merger could be expected to operate against the public interest, a remedy involving the sale of VWUK's holding in South Staffs Group would pre-empt any future move by VWUK to exercise influence over that company. South Staffs Group had researched the market and believed there would be an appetite among investors for the shares currently held by VWUK.

Swan Group PLC

8.67. Swan Group PLC (Swan) consists of Mid Kent Water, Inenco Group, Eclipse Scientific Group and Halcrow Water Services. Mid Kent Water provides water services for nearly 600,000 people.

8.68. Swan summarized the improvements in the water industry since privatization: capital investment in the industry had increased and water quality and customer services had improved. In addition, price increases had been constrained by increases in capital and operating efficiencies. Swan believed that these advances were partly attributable to the regulatory regime.

8.69. Swan added, however, that latterly the regulatory regime had squeezed companies too hard. As a result, the industry was now characterized by confused corporate restructuring, a trend towards the disaggregation of operations from asset ownership and the reluctance of equity investors to invest.

8.70. Swan argued that the regulatory regime had diminished the effectiveness of the equity model, as inefficient companies were not at risk of a takeover unless mergers were allowed to take place on sensible terms. Moreover, the maintenance of a large number of WoCs and WaSCs prevented the realization of synergies and efficiency savings, which if realized could result in price reductions.

8.71. Swan recognized that the regulator's primary means of assessing efficiency was through the use of comparators. It did not believe, however, that there was any evidence justifying the need for 23 comparators for water supply when there were only ten for sewerage companies. Swan suggested that the regulator should look to other utility industries where regulation occurred with fewer comparators, and should consider benchmarking against competitors overseas.

Water and sewerage companies

AWG plc

8.72. AWG is a water services and infrastructure management group, one of whose subsidiaries is Anglian Water Services Limited, a WaSC. AWG provides a range of infrastructure support services to the utility, transport and public sector markets.

8.73. AWG stated that it did not oppose the merger, as it did not believe that it was against the public interest.

8.74. AWG recognized that the merger might result in a small reduction in the DGWS's ability to make comparisons between water enterprises. AWG argued, however, that in the 13 years since privatization the regulatory regime had succeeded in improving the efficiency of the water industry and raising the position of the least efficient companies near to that of the most efficient ones. As a result, the scope for efficiency savings had been reduced and thus the value of the comparative regime had reduced with it.

8.75. AWG argued that consolidation was required to draw further efficiency gains from the industry. It therefore supported the proposed merger.

Severn Trent Plc

8.76. Severn Trent is an environmental services group providing water, waste and utility services. Severn Trent Water is one of the largest of the ten WaSCs, serving a population of approximately 7.4 million.

8.77. Severn Trent stated that the merger would not have any material impact on the ability of the DGWS to make comparisons between water companies because alternative approaches made it possible to carry out effective analysis with fewer companies. Moreover, the water industry would benefit from rationalization through mergers.

8.78. Severn Trent cited VWUK's announcement on 7 May 2002 which stated that, to counter any detriment to the comparative regime caused by the merger, VWUK had proposed to create a new comparator, a proposition Ofwat was said to have accepted. Severn Trent argued that, if there had been any shift in Ofwat's position on the need for comparators, and the possibility of retaining comparisons through data separation, then such a shift in policy should have been announced, rather than arrived at through private negotiation.

Thames Water Utilities Ltd

8.79. Thames Water is the largest WaSC by turnover, serving a population of nearly 13 million.

8.80. Thames cited a report by Indepen which suggested that halving the number of companies that supplied water in England and Wales would result in savings of £6 billion. Thames agreed that substantial savings would occur if water undertakers were allowed to merge and that these savings could be passed on to customers. It did not, however, entirely concur with the figure of £6 billion.

8.81. Thames stated that the regulator's imposition in the past of an initial price reduction on newly merged companies served only to delay the delivery of benefits to customers. Consequently, it did not believe that the public interest would be served if the merger was passed subject to a condition of this kind, as that would serve to delay or reduce the benefits to customers.

8.82. Thames argued that it should not be necessary to maintain the current number of comparators in order to maintain an adequate number of regulatory comparators.

United Utilities Water Plc

8.83. UUW is owned by United Utilities, a diversified multi-utility active in regulated and non-regulated businesses. Its regulated businesses are in water and sewerage and electricity distribution. UUW, the third-largest WaSC by turnover, supplies water and sewerage services to a population of some 6.8 million in the North-West of England.

8.84. United Utilities Contract Solutions holds a four-year contract to manage the water and waste-water assets of Dŵr Cymru as well as a £15 million contract to install and replace its water meters. UUW told us that decisions concerning strategic management and investment were taken by the directors of Dŵr Cymru: United Utilities' focus was on executing Dŵr Cymru's strategic decisions. United Utilities managed opex but Dŵr Cymru's strategic decisions had a clear influence over opex in the longer term through the level and type of investment. UUW considered that one of the benefits of United Utilities' contract with Dŵr Cymru was the transfer of technical know-how.

8.85. UUW argued that the merger would not materially reduce the number of comparators in the UK. UUW highlighted the possibility that the merger could result in improvements to Southern, thus providing Ofwat with a higher quality comparator. UUW believed that the ability to use other techniques for assessing efficiency and opportunities to compare UK water companies against their international counterparts reduced the significance of the number and quality of UK comparators. UUW also argued that in regulated industries where few or no comparators existed, there had nonetheless been significant efficiency improvements.

8.86. UUW viewed the merger as part of a well-established process of consolidation within the industry, a process which conferred benefits on customers through economies of scale and the transfer of best practice, ultimately leading to increased efficiency and lower prices for customers.

8.87. UUW argued that, in a competitive market, managers sought to improve efficiency and achieve results set by their stakeholders partly for fear of the company being taken over. The automatic referral of water industry mergers to the CC, and the legislative provisions against which the CC had to consider mergers, removed this pressure. UUW believed the regime acted to prevent the process of natural selection that occurred in a competitive market.

8.88. UUW highlighted the contrast between the ease with which foreign companies could acquire UK water companies and the difficulties imposed on UK water companies wishing to acquire another water company to enable them to develop the scale to compete on an international level.

8.89. UUW argued that the Enterprise Bill should be amended to remove the provision requiring the automatic referral of water company mergers to the CC. The present proposition was inconsistent with the position in electricity where no such requirement existed.

Wessex Water Plc

8.90. Wessex provides water supply and sewerage services to a population of some 1.2 million in the South-West of England.

8.91. Wessex stated that the merger offered the opportunity to eliminate the overlaps and inefficiencies which occurred through the duplication and overlapping of WoCs and WaSCs, inefficiencies that were difficult to eliminate through contracts alone.

8.92. Wessex recognized the significance of comparators but questioned whether the present number was necessary or appropriate given the desire in the industry to reduce prices and maximize quality and efficiency.

Utility groups

Centrica Plc

8.93. Centrica Plc (Centrica) is an energy supplier in the UK, Belgium and North America, as well as providing other consumer services in telecoms, roadside recovery and financial services. Its four principal consumer brands in the UK are the AA, British Gas, Goldfish and One.Tel, but the company also had aspirations to expand its business into the water industry.

8.94. Centrica challenged the merits of comparative efficiency as a means of regulating the water industry. It acknowledged that the regulatory regime had delivered positive results since privatization, but argued that diminishing returns would begin to occur as the industry moved towards an efficiency frontier typical of a monopolistic rather than a competitive market.

8.95. Centrica argued that past difficulties encountered by the MMC and Ofwat in establishing consistent criteria by which to judge the value of the detriment arising from mergers brought into question the value of using such criteria. Centrica cited further regulatory thinking by Ofgem which it believed supported this assessment.

8.96. Centrica stated that, if Ofwat was to continue to use Southern as the opex benchmark company for the next periodic review, other companies would have legitimate cause to challenge the statistical validity of Southern's results, and any consequent catch-up targets, given Southern's merged status. Centrica believed that the perceived contamination of a benchmark comparator's results after a merger had a greater impact on the effectiveness of the regulatory regime than if a lower performing company were to merge.

8.97. Centrica referred to the draft Water Bill that the Government had published in November 2000, which signalled that Ofwat's duty in respect of competition was to change from one of facilitating competition to one of promoting it. Centrica argued that the collection of separate evidence for each element of the value chain would assist this change. To obtain such evidence and to encourage competition it advocated that, should the CC allow the merger either with or without a divestment remedy, the following pro-competitive measures should be applied: the establishment by VWUK of an independent retail comparator operated at arm's length from the rest of the business; the introduction of two separate price controls, one for retail and one for the balance of activities; and a requirement to overhaul Southern's network access code to ensure equal treatment and charges for new entrants in advance of common carriage competition for large water users.

P MACKAY *(Chairman)*

C F W GOODALL[1]

A HADFIELD

D PARKER

P STODDART

R FOSTER *(Secretary)*

23 September 2002

[1]Chris Goodall signs subject to his Statement of dissent which follows Chapter 2 and to the points of dissent noted in the body of that chapter.