EXPLANATORY MEMORANDUM TO

THE WATER MERGERS (MISCELLANEOUS AMENDMENTS) REGULATIONS 2015

2015 No. 1936

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Environment, Food and Rural Affairs and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations apply the statutory provisions and timescales for the assessment of general mergers under the Enterprise Act 2002 (the "2002 Act") to the assessment of water mergers by the Competition and Markets Authority (CMA) under the Water Industry Act 1991 (the "1991 Act"). This is to streamline the process and provide certainty of the process to all parties to the water merger.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to the negative procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 These Regulations amend the Water Mergers (Modification of Enactments) Regulations 2004 (the "2004 Regulations") as a result of the amendments made to the special merger regime for water companies by section 14 (*Exceptions to duty and undertakings in lieu of merger references*) of the Water Act 2014 (the "2014 Act").

4.2 Section 14 of the 2014 Act inserted new provisions into the 1991 Act in order to reform the special merger regime for water companies. These changes remove the requirement of an automatic referral of all water mergers to an in-depth Phase 2 investigation by the CMA and instead allow some water mergers to proceed following a Phase 1 investigation by the CMA. This includes the possibility for the CMA to accept undertakings from the companies in lieu of a merger reference.

4.3 Paragraph 1 of Schedule 4ZA to the 1991 Act provides that Part 3 of the 2002 Act (containing the general merger provisions) shall apply with such prescribed modifications as may be necessary in relation to water mergers and references of water mergers under the 1991 Act as it applies in relation to mergers which are considered under Part 3 of the 2002 Act. The 2004 Regulations therefore applied the general merger regime contained in Part 3 of the 2002 Act with relevant modifications to the water merger regime. These Regulations amend the 2004 Regulations to

modify certain provisions of Part 3 of the 2002 Act for the purposes of assessing water mergers under the revised merger regime.

4.4 The Enterprise and Regulatory Reform Act 2013 (the "2013 Act") amended Part 3 of the 2002 Act to introduce statutory timescales to all parts of the two-phase merger process. Now that there will be a two-phase assessment for water mergers as in the general merger regime, these Regulations apply the timescales set out in Part 3 of the 2002 Act to the assessment of water mergers under the 1991 Act.

4.5 These Regulations also amend the Enterprise Act 2002 (Merger Fees and Determination of Turnover) Order 2003 (the "Merger Fees Order"). The Merger Fees Order provides for a fee to be payable to the CMA in respect of a merger reference made by the CMA. These Regulations amend the Merger Fees Order so that a fee will also be payable to the CMA when the CMA makes its Phase 1 assessment of the water merger.

5. Extent and Territorial Application

5.1 The extent of this instrument is that Part 2 of the Regulations extend to England and Wales and Parts 3 and 4 of the Regulations extend to all of the United Kingdom, as the enabling power to amend the Merger Fees Order extends to all of the United Kingdom.

5.2 The territorial application of this instrument is that Part 2 of the Regulations which amend the 2004 Regulations applies to England and Wales only and the amendments in Parts 3 and 4 to the Merger Fees Order are only likely to have effect in relation to water mergers in England and Wales, as the 1991 Act only applies to England and Wales.

6. European Convention on Human Rights

6.1 These regulations are subject to the negative resolution procedure but as they modify primary legislation the Parliamentary Under Secretary of State for Environment and Rural Affairs has made the following statement regarding Human Rights:

"In my view the provisions of The Water Mergers (Miscellaneous Amendments) Regulations 2015 are compatible with the Convention rights."

7. Policy background

What is being done and why

7.1 The 2014 Act will reform the water industry to help us face future challenges arising from a growing population and changing climate. The 2014 Act will amongst other things reform the special merger regime for water. At present the CMA must refer any mergers between incumbent water companies to its Mergers Panel where one or both of the parties has an annual turnover of £10 million or more[1]. This effectively means any merger between incumbent water companies would have to be referred. The CMA Panel must then determine whether the loss of one or more of the water companies (comparators) is going to have an impact on Ofwat's (the industry's independent economic regulator) ability to regulate using comparative regulation.

[1] The most recent referral happened in 2015 after Pennon Group Plc, parent company of South West Water, acquired Sembcorp Bournemouth Water Investments Limited (https://www.gov.uk/cma-cases/pennon-group-sembcorp-bournemouth-water-investments-merger-inquiry).

This is when Ofwat uses comparative information between different water companies to identify the best performing company within the sector for certain activities and requires the other companies to improve to meet that level of performance. Following a merger between two water companies the number of comparators available to Ofwat would decrease and this could affect its ability to undertake this kind of regulatory test.

7.2 The reforms in the 2014 Act enable the CMA to decide not to make a merger reference if:

- in the case of an anticipated merger, the merger arrangements are not sufficiently advanced or are unlikely to proceed (for example if negotiations have stalled); or
- the merger (anticipated or otherwise) is not likely to prejudice Ofwat's ability to regulate (for example if one of the water companies is not subject to comparative regulation or if it is not a suitable comparator); or
- although the merger (anticipated or otherwise) is likely to prejudice that ability, the benefits to customers by allowing the merger outweigh the loss of a comparator (for example if the merger produces lower prices or higher quality services for the customer).

7.3 Prior to making this decision the CMA must consult Ofwat, and Ofwat must respond, on how the proposed merger might impact on its ability to regulate and how that weighs against potential customer benefits. In determining the impact Ofwat must use its Statement of Methods, which it is under a duty to publish. Ofwat's Statement of Methods should give acquiring water companies and the CMA some certainty about whether a proposed merger would prejudice its ability to regulate and the likely impact. The CMA must consider Ofwat's opinion before coming to a decision. This is known as a Phase 1 assessment, while the reference to the CMA Mergers Panel triggers the Phase 2 assessment.

7.4 The reforms will also allow the CMA to accept undertakings from parties to the merger for the purposes of remedying or mitigating the impact of losing a comparator instead of making a merger reference. These undertakings might include continuing with separate price limits, divestment of some or part of the business of the merged entity, etc.

7.5 The reforms introduced by the 2013 Act include statutory timescales to improve the speed, quality and robustness of the CMA's decision making in the wider merger regime. These have been applied to the special merger regime. Phase 1 will have a 40 working day timescale starting on the first working day after the CMA has informed the merging water companies that it has sufficient information to begin its assessment. On announcement of its Phase 1 decision, the CMA can decide that there are no possible undertakings in lieu of a Phase 2 assessment that would address its concerns about the loss of a comparator. If the CMA does not make that decision, the merging parties will have five working days to offer undertakings after the CMA announces its Phase 1 decision. The CMA, in consultation with Ofwat, will then have up to the tenth working day after the date of the decision to consider any undertakings proposed by the parties.

7.6 The 2015 Regulations amend the original 2004 Regulations, and at present there are no plans to consolidate them.

8. Consultation outcome

8.1 In September 2009, Defra and the Welsh Government undertook a public consultation on the recommendations from Professor Martin Cave's Independent Review of Competition and Innovation in Water Markets[2]. The consultation sought views from stakeholders and the general public on competition in the water and sewerage sector as well as the specific recommendations of the Review. In total 53 responses were received.

8.2 The specific question around reform of the special mergers regime[3] was answered by 17 respondents, including Ofwat, the Consumer Council for Water and 12 water companies, and all supported the proposed reforms. The remaining responses to the consultation either did not provide an answer to the question or did not express a particular view either way.

8.3 Following the consultation the Government published its response in the Water White Paper, Water for Life[4], to

"…use a future Water Bill to introduce a two-tier referral system, allowing water companies seeking to take over another water company to make undertakings in lieu of an expensive referral to the Competition Commission".

8.4 Further to the Government consultation both Ofwat, on its new Statement of Methods, and the CMA, on its new Guidance, have held consultations during 2015.

9. Guidance

9.1 As part of the reformed regime Ofwat, as set out in the 2014 Act, must publish a Statement of Methods on how it would make an assessment of a potential merger. In publishing this statement it should give the companies and the CMA greater clarity about whether a proposed merger (taking into account any undertakings) would prejudice Ofwat's ability to regulate and the likely impact of that prejudice. Ofwat published its Statement on 26 October 2015[5].

9.2 Alongside this the CMA have also published new guidance[6] explaining the new regime and how it will approach Phase 1 assessments, what procedures it will take, and its approach for analysis.

10. Impact

10.1 There will be no perceived impact on business, charities or voluntary bodies. These reforms only apply to water companies in England and Wales, are deregulatory and could potentially lead to savings through reduced administrative costs.

10.2 The impact on the public sector is thought to be minimal as the costs of the CMA are recovered through merger fees and Ofwat's costs may be reduced because its advice to the CMA will be based on published criteria rather than produced on a case by case

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[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69462/cave-review-final-report.pdf

[3] Do you agree to the Government's suggested approach to the first phase referral of water mergers to the OFT and that the OFT should been given powers to accept undertakings in lieu of reference of water mergers to the CC?

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228861/8230.pdf

[5] http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_pos20151021mergers1.pdf

[6] https://www.gov.uk/government/publications/water-and-sewerage-mergers-cma49

basis. By reforming the merger regime there may be fewer Phase 2 referrals to the CMA Mergers Panel.

10.3 An Impact Assessment was produced and updated throughout the consultations and in advance of the Water Bill entering Parliament in June 2013. A copy has been published[7] alongside the 2014 Act on www.legislation.gov.uk.

11. Regulating small business

11.1 The legislation does not apply to activities that are undertaken by small businesses. Mergers between water companies where the turnover of both companies is less than £10 million are not subject to the special merger regime. The special merger regime only applies to water companies within England and Wales where one or both companies have a turnover over £10 million and are deregulatory in nature; therefore it was felt unnecessary to take any further actions to minimise the impact on, or to assist, small businesses.

12. Monitoring & review

12.1 The Secretary of State must review the amendments made by the 2015 Regulations in relation to water mergers after five years and publish a report setting out the extent to which the 2015 Regulations have met their intended objectives and whether those objectives are still appropriate for legislation, and if so the extent to which they could be achieved with less regulation. Subsequent reports must be published at intervals not exceeding five years.

12.2 The 2014 Act (section 15, *Exclusion of small mergers: advice of CMA on threshold*) also requires the CMA to keep the £10 million threshold under review and advise the Secretary of State whether it remains appropriate.

13. Contact

13.1 For queries regarding this instrument please contact David Jones at the Department for Environment, Food and Rural Affairs. Telephone: 020 7238 5989. Email: david.jones@defra.gsi.gov.uk.

[7] http://www.legislation.gov.uk/ukpga/2014/21/impacts/2012/2043