



# The Cave review

CONSOLIDATION IN THE UK WATER SECTOR

Professor Martin Cave has completed a year-long review of competition and innovation in the UK water sector and has made wide-ranging recommendations to government to make radical changes to the current regime. One of the most interesting proposals, particularly for current and potential water company investors, is the proposal to relax the regime that has to date inhibited water company consolidation. This briefing provides an overview of Professor Cave's findings and considers the water deals that might benefit from regime change.

## Major changes proposed to stimulate competition in the water sector

Professor Martin Cave (Professor and Director of the Centre for Management under Regulation at Warwick Business School) has now completed his in-depth review of competition and innovation in the UK water sector and has made a series of recommendations for regime change to government.

Cave's proposed changes are nothing less than a blueprint for wholesale reform of the sector – seeking to break the near-monopoly positions of UK water companies and to stimulate investment in water infrastructure.

Significantly for water investors, Cave proposes relaxing the special water merger regime which to date has inhibited water company consolidation.

## The recommendations

- Gradual introduction of mechanisms to increase greater upstream competition, including the unbundling of current combined supply licences to create a new upstream licence.
- Amend the rules at the retail level, so that in due course all non-household customers will be able to choose their water supplier.
- Make smaller water company consolidation much easier. At present, all water company consolidation involving water companies with turnover of more than £10m is subject to a mandatory Competition

Commission inquiry. The review proposes raising the threshold to £70m, allowing mergers between smaller companies that don't raise particular and specific competition concerns.

- Introduce a new one-stage assessment of the effect on comparative competition by the Office of Fair Trading (OFT) under the special water merger regime. This would replace the system whereby all water company mergers are automatically referred to the Competition Commission.
- Create an industry research and development body, with an overarching water strategy to encourage investment into research and development.
- Replace the current system of abstraction and discharge licences.

## Is this a stimulus for water consolidation?

For water industry investors, the changes to the special water regime are very significant.

While it is unlikely to lead to consolidation of the major water and sewerage companies, smaller water-only companies will qualify under the increased thresholds.

At least six water-only companies have turnover of less than £70m and a number of these have been the subject of significant investor interest in recent years. These companies are much more likely to be subject to consolidation if the review adopts the merger proposals.

In addition, the proposed introduction of a 'phase 1' review of water mergers could allow large water

companies (or investors in those companies) to achieve a significantly shorter review of any proposed merger than the current mandatory reference to the Competition Commission, which can take up to 32 weeks.

The introduction of the phase 1 review process should allow parties to test and get certainty on water interest ownership structures that have been deployed to date in order to avoid a mandatory Competition Commission reference.

This will be particularly useful for investors interested in minority stakes in multiple water interests.

## Government and Ofwat reaction

Initial reaction to this report (and earlier reaction to Professor Cave's interim report) from government and Ofwat (The Water Services Regulation Authority) has been positive.

It is worth noting the choice of Professor Cave for this review, since in 2002 he carried out a review of the radio spectrum sector. The government largely approved of his proposals in that review and formalised his changes on radio spectrum management in the Communications Act 2003.

On the special merger regime, Ofwat is keen to maintain the safeguard of the comparator test, but supports a phase 1 review by the OFT. It has suggested that where retail service companies are structurally separated from the other regulated businesses, they should be excluded from all special merger controls, at least where customers are able to choose their supplier.

## Next steps

The next step is for the government and Ofwat to consider the proposals with stakeholders.

Ultimately government will need to table legislative changes in order to bring out the changes proposed by Professor Cave and it is not clear when it will begin this process (or indeed how far the recommendations will be taken). Given other political and legislative priorities, these proposals may be delayed well into any government's new term.

That said, its signals to date show that there is a desire for change that will herald a new era of competition – and potential consolidation – for water supply in the UK.

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