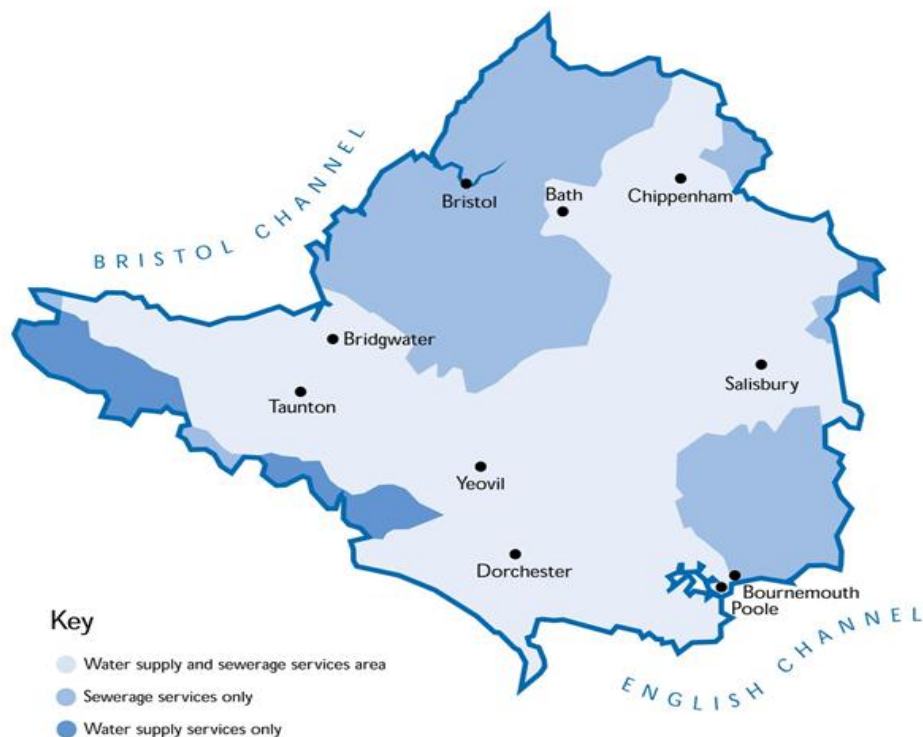


CMA Phase 2 Merger Investigation – Pennon Group and Sembcorp Bournemouth Investments

Submission to the Inquiry Group from Wessex Water Services Ltd

Introduction to Wessex Water

1. Wessex Water Services Ltd is the statutory appointed water and/or sewerage undertaker for a region in the southwest of England that covers large parts of Wiltshire, Somerset and Dorset as well as the conurbations of Bristol and Bournemouth. Wessex Water serves 1.3 million customers for water services and 2.7 million customers for sewerage services.
2. The difference in the size of our appointed areas is explained by the fact that our sewerage area of appointment includes almost all of the area of Bristol Water PLC's water area of appointment as well as most of the area covered by Sembcorp Bournemouth Water in the south-east of our region.
3. A small number (~1500) customers in the south-west of our region receive either water or a sewerage service from us and the other service from South West Water.



4. The parent company of Wessex Water Services Ltd is Wessex Water Ltd. Wessex Water Ltd also owns 50% of the share capital of Bristol Wessex Billing Services Ltd

(BWBSL), a joint venture company set-up with Bristol Water to provide retail services for both Wessex and Bristol Water.

5. We have recently entered into an innovative resilience bulk supply water trading agreement with Sembcorp Bournemouth that provides both of our customer bases with additional resilience in their water supply services and has allowed significant investment in water resource assets to be avoided for both companies.
6. We share a water resource (Wimbleball reservoir) with South West Water in the south-west of our region.
7. In 1996 a Wessex Water bid for South West Water was blocked by the then Monopolies and Mergers Commission because the merger “would prejudice [Ofwat’s] ability to make comparisons between different water enterprises”.

Our Views on Industry Consolidation

8. We consider that the scope of restrictions on merger activity since 1996 is likely to have reduced the efficiency challenge from equity and reduced innovation in the sector. Given the long-term challenges the industry faces we believe it is in customers’ interests to reduce the level of restriction of mergers.
9. The industry structure is already changing and there will be scope soon for demergers of some activities and greater scope for new market entrants which will mitigate any perceived risks of greater consolidation in some parts of the water market.

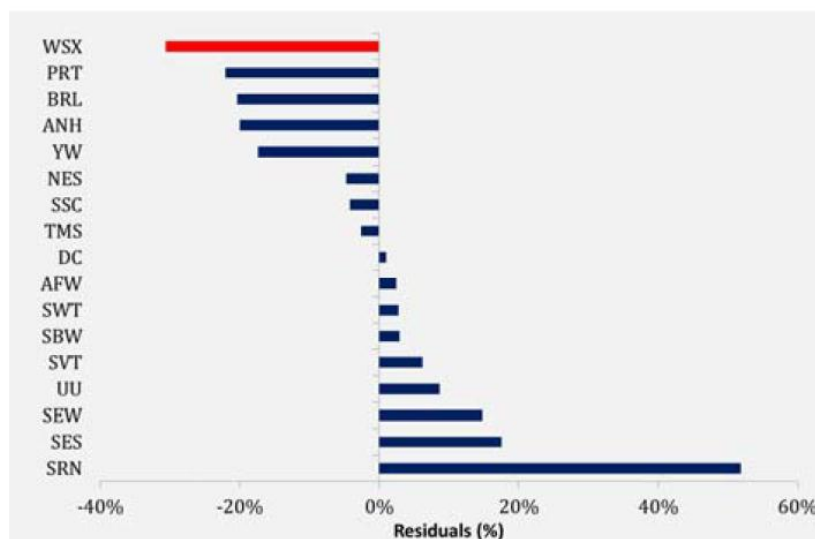
Our Views on the Loss of a Comparator

10. Sembcorp Bournemouth has a deserved reputation for being a well-run company with good levels of service, however because of their relatively small size - Bournemouth Water is the 16th smallest water company (out of 18) by turnover and 17th by customer numbers we do not think that their loss as a comparator should prejudice Ofwat’s abilities to make comparisons between companies.
11. We also note that Ofwat accepted arguments from Bournemouth that a premium to the cost of capital was appropriate due to the company’s small size. This will be avoided with the proposed merger, saving money for customers in the Bournemouth area.

Household Retail Services

12. We understand that the loss of a comparator company at the modelled efficiency frontier is likely to be of greater significance than that of another company.
13. As part of our recent PR14 submission we commissioned an econometric analysis of relative efficiency in household retail services from Economic Insight based on 2013-14 data which showed that both South West Water and Bournemouth Water were slightly below average efficiency.

Figure 3. Residuals (percentage) from preferred model



Source: Economic Insight

14. The analysis from Economic Insight excluded the costs of bad debt which are relatively low for Sombcorp Bournemouth and relatively high for South West – driven primarily by the relative bill levels and levels of deprivation in the different regions
15. We note that it should be just as possible for the new Group to increase household retail efficiency in the Bournemouth area to levels closer to those seen at Wessex and Bristol Water (both at or near the efficiency frontier) by taking advantage of the economies of scope available in retail services by billing for two services rather than one.
16. In the water industry the primary measure of the quality of retail services is the SIM score. Bournemouth has been an upper quartile performer each year since the SIM's inception, whilst South West (whilst significantly improving their score over the period) has remained 4th quartile for all published years. While the loss of Bournemouth as an upper quartile company is regretful, there are reasons to believe the loss will not be keenly felt, as:
 - It presents South West an opportunity to transfer Bournemouth's knowledge in this area to improve retail service performance in the original South West region for a greatly expanded customer base.
 - The upper reaches of the SIM metric have become very congested recently as companies have improved their customer service. Bournemouth's 2013-14 score of 86.8 (3rd) is contrasted with 10 companies achieving a score >83 in 2013-14, 7 achieving a score >85 and 4 achieving a score >86.

Non-Household Retail Services

17. We note that South West Water and Bournemouth Water have a low average cost to serve for non-household retail services, but in any case in this area there should

be little concern given that the market for non-household retail services will be fully open to competition from April 2017 and the need for comparators will be removed.

Wholesale Water Supply Services

18. We note that both South West Water and Bournemouth Water were judged by Ofwat to be upper quartile efficient for totex in the most recent price review (PR14), and we therefore expect that there may be some concerns about the lessening of the efficiency challenge for other companies at future price controls - this is because Ofwat set other companies' allowed totex at PR14 after an adjustment reflecting their view of the modelled gap to the upper quartile efficiency level.
19. The validity of Ofwat's modelling approach at PR14 is we expect a matter that the CMA is currently reviewing in its separate enquiry concerning Bristol Water's appeal of their final determination – nevertheless the results of Ofwat's efficiency modelling imply that relative efficiency between companies can change very quickly.
20. The following table shows the efficiency assessments for water and sewerage companies and how they have changed in the five years between PR09 and PR14. None of the companies judged to be upper quartile efficient at PR09 were judged to be upper quartile efficient at PR14.

Water service efficiency assessment	PR09 Opex	PR09 Capex	PR14 Totex
Anglian	1 st Quartile	1 st Quartile	2 nd Quartile
Dwr Cymru	4 th Quartile	3 rd Quartile	4 th Quartile
Northumbrian	2 nd Quartile	1 st Quartile	2 nd Quartile
Severn Trent	2 nd Quartile	2 nd Quartile	1 st Quartile
South West	4 th Quartile	3 rd Quartile	1 st Quartile
Southern	1 st Quartile	2 nd Quartile	4 th Quartile
Thames	2 nd Quartile	3 rd Quartile	3 rd Quartile
UU	2 nd Quartile	1 st Quartile	4 th Quartile
Wessex	2 nd Quartile	1 st Quartile	3 rd Quartile
Yorkshire	1 st Quartile	1 st Quartile	2 nd Quartile

21. In this context there is less reason to expect that there will be a detriment to customers at a future price control if two companies judged to be efficient at the previous price control merge.