



**Initial submission
to the Competition
and Markets Authority**

from Pennon Group Plc
June 2015

NON CONFIDENTIAL

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1. OVERVIEW OF SUBMISSION

- 1.1 Further to receipt of the Competition and Markets Authority (CMA) letter of 8 June 2015, this response seeks to address the questions raised by the CMA as a result of the acquisition of Bournemouth Water Investment Limited (BWIL) by Pennon Group Plc (Pennon) which completed on 15 April 2015. The information provided is supplemental to the initial factual information response submitted to the CMA on 15 June 2015 and the Phase I submission dated 18 May 2015.
- 1.2 The acquisition and connected activities has been given the code name “Project Bronze” by Pennon, and Bournemouth Water (BW) may be referred to as “Bronze” in some documents.
- 1.3 Pennon is advised by Oxera Consulting LLP (“Oxera”) who have assisted in the production of economic analysis and modelling prior to the acquisition and in support of Pennon’s submissions to the CMA and Ofwat. Pennon is also advised by Linklaters LLP, Solicitors. See the Professional Advisers Credentials in section 15.
- 1.4 As with other documents already submitted to the CMA, this document has been prepared by Pennon, with some input from BWIL’s management team. The contents of this submission and associated appendices are confidential to Pennon, but, in principle Pennon consent to the CMA sharing with Ofwat information and documents provided by Pennon with respect to this submission (subject to appropriate authorisation). Where documents contain BWIL’s commercially sensitive information that has not been shared with Pennon, this information will be provided under a supplemental submission by Linklaters on BWIL’s behalf.

2. STATEMENT OF CASE – HIGHLIGHTS

Merger of two culturally similar, well performing companies

- SWW only Water and Sewerage Company (WaSC) to obtain enhanced status for PR14 business plan with strong focus on customer engagement
- BW small Water only Company (WoC) (5% size of SWW)
- merged entity 2nd smallest WaSC
- BW recognised as top performing company for customer service
- merged entity well positioned to enhance service further for the benefit of all customers
- operationally similar environment

Beneficial merger i.e. non-prejudicial

- merger will not prejudice Ofwat's ability to make comparisons
- small 'technical detriment' in some modelled scenarios (SIM); significantly outweighed by wholesale synergy savings [REDACTED]
- other significant retail synergy savings
- other additional benefits e.g. structural change and financing flexibility
- significant customer support for the merger

Approach

- merge wholesale activities
- merge retail household activities
- merge retail non-household businesses and legally separate
- separate reporting of performance in 2015-2020

Benefits customers, regulators and stakeholders

- improved service for customers
- better comparator for Ofwat pushing the frontier benchmark
- 'new' comparators

Sharing of benefits

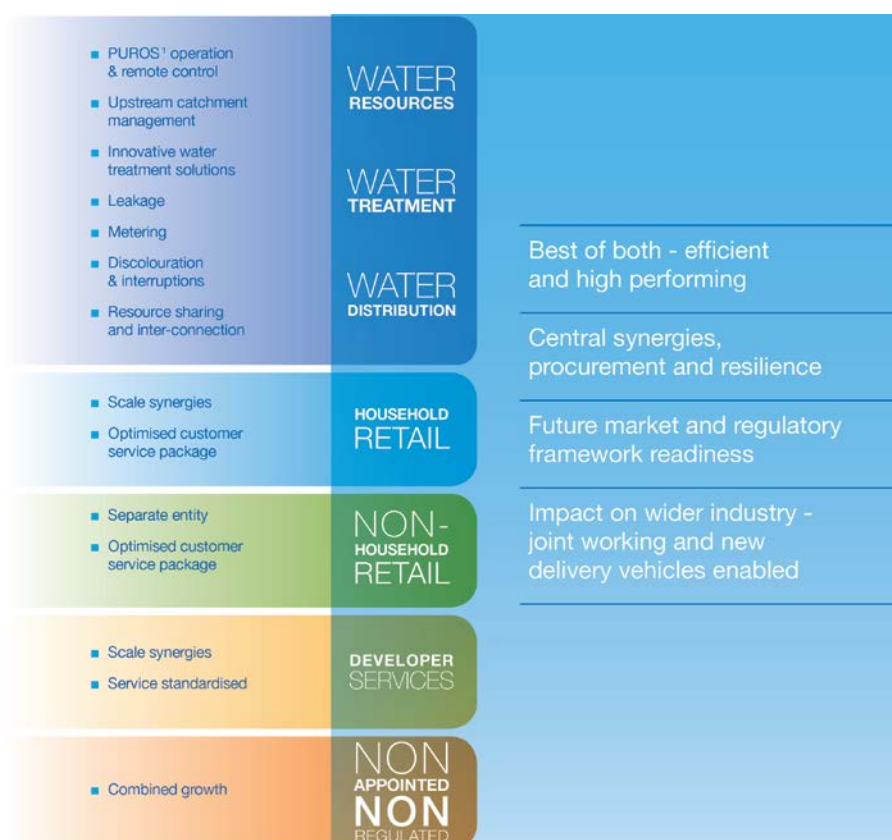
- reduction in financing allowances
- PR19 automatically shares wholesale synergy savings
- synergistic cost savings shared – wholesale and retail

3. EXECUTIVE SUMMARY

- 3.1 Subject to receiving approval for the merger following an automatic reference under Section 32 of the Water Industry Act 1991 (as amended) (WIA), Pennon intends to merge BW with another of its other wholly owned subsidiaries, South West Water Limited (SWW).
- 3.2 This merger combines SWW, the smallest Water and Sewerage Company (WaSC) by turnover, with BW, a small Water only Company (WoC) by turnover (5% the size of SWW), resulting in a merged entity which will become the second smallest WaSC by turnover in England and Wales.
- 3.3 Pennon believes the merger will not prejudice Ofwat's ability to make comparisons for regulatory purposes and consequently the question of remedies does not arise. However, the merger will produce net benefits for Ofwat's comparative regime, and generate a number of merger specific benefits, which underpin the rationale for this merger.
- 3.4 **Pennon considers the merger is in the best interests of customers, investors, the wider industry regulatory regime and its investment enables these additional outcomes to be unlocked.**
- 3.5 SWW is a leading performer in the industry across a number of areas. It was the only WaSC that was given an 'enhanced' status in PR14. The diagram below at 3.6 presents the results of Ofwat's risk-based review assessment of company business plans, across those issues that were tested for pre-qualification (to enhanced status) in March 2014.
- 3.6 The diagram clearly shows that, on the majority of measures, SWW was a better performer than BW in terms of the quality of its business plan, and scored A ('exceptional') or B ('sufficient and convincing') in most areas, while BW scored B or C (not sufficient or convincing) in most areas.

		SWW				BW		
Area	RBR pre-qualification test	Retail	Wholesale water	Wholesale wastewater	Whole company	Retail	Wholesale water	Whole company
Outcomes	1. Customer engagement and willingness to pay evidence	A	A	A		C	C	
	2. Performance commitments	B	C	C		C	C	
Costs	4. Wholesale cost assessment - costs		A	A			C	
	4. Wholesale cost assessment - evidence		B	B			B	
	4. Wholesale cost assessment - overall		B	B			C	
	5. Retail cost allocation	B				D		
	6. ACTS adjustment	C				C		
Risk and reward	13. Affordability				B			B
	14. Adjustments to 2015-20 price controls		A	A			B	
	15. Board assurance of a high-quality business plan				B			B

- 3.7 In relation to wholesale cost assessment (water service), note that SWW scored A in terms of its costs and B in terms of its evidence, with an overall score of B. SWW was one of only three companies in the industry to score A in terms of its costs.
- 3.8 This performance position will not be diminished as a consequence of this merger, and in fact the combined entity will be enhanced.
- 3.9 Following the CMA approval for the merger, the intention of Pennon is to operationally merge BW retail activities (non-household and household) with SWW retail activities.
- 3.10 The combined incumbent non-household retail business will be legally separated from the wholesale and retail household businesses for the purposes of retail market development.
- 3.11 Pennon’s plans for SWW and BW are to combine the best of both companies, implement changes that will deliver synergies and savings whilst improving customer services, producing business growth across the value chain. As a result of the merger, structural flexibility will be enabled, as existing securitisation can be unlocked. **Only as a direct result of the merger can the following outcomes be realised:**



- 3.12 The merger plans are designed to enable separate elements of wholesale as well as retail operations to be targeted for change and innovation.
- 3.13 Wholesale water activities will be organised centrally, resulting in savings on overhead costs using SWW innovations and new technology while local operational staff will

continue to run operations in each region. The merger process will also act as an enabler for retail and upstream market reform. Resilience of services will be improved across a wider area than covered by the separate undertakings. This is detailed in section 6.

- 3.14 The intention of Pennon is to combine BW non-household retail and household with SWW retail activities. The combined incumbent retail non-household business will subsequently be legally separated for the purposes of retail market development.
- 3.15 Following approval, Pennon plans for a new licence structure for the combined wholesale / retail activities to be put in place following discussion with Ofwat. This will provide the opportunity for new forms of water company licences to be considered.
- 3.16 Strong, robust customer engagement and consultation is already within the ethos of both businesses. Research undertaken ahead of the acquisition by Pennon indicates that **customers strongly support the benefits that emerge from this type of merger**. See Annex G for details on this customer research.
- 3.17 Pennon will be transparent about the progress they make in delivering value from the acquisition. SWW and BW both developed mechanisms for reporting performance in 2015-2020. Both of these will be used to ensure ongoing engagement with both communities and link to the development of future plans. This is detailed in section 6.
- 3.18 In conclusion, building on SWW and BW strengths in wholesale and retail, the merged entity will benefit Ofwat's ability to make comparisons between water companies. There will be benefits for all water service customers, in terms of reduced prices and other non-price benefits such as innovation and improved customer services.

CUSTOMER OUTCOMES AND BENEFITS

- 3.19 Not only are there benefits to Ofwat's ability to make comparisons, but also direct benefits to the customers of SWW and BW.
- 3.20 The merger will give rise to significant efficiency benefits. These will be passed back to customers following delivery, in K7. Whilst there is no requirement to pass back savings as technically there is no prejudice, Pennon is proposing to reduce the allowance for financing given to BW as the rationale for this uplift (small company premium) will no longer be in place.
- 3.21 **The reduction of corporate costs of operating two separate companies**, which will be available to be shared with the combined entity's customers at the 2019 Price Review (PR19) **will result in lower bills for customers**.
- 3.22 As described in section 6, evidence shows that the relevant customer benefits will accrue as a result of the merger, can only achieve the same quantum of benefit through a merger and are quantifiable and will be realised within a reasonable period of the merger.

- 3.23 No customer from either SWW or BW will be worse off from the merger – **customers will only gain from the merger**. Customer bills and service levels committed in the 2014 Final Determination will be delivered as a minimum.
- 3.24 The operational merger of SWW and BW will result in lower costs across both companies. These cost synergies can only be delivered by the merger and will be delivered over the next two to three years and focused in the following areas:
- sale of land and surplus operational properties [xxx]
 - reduced overheads [xxx] per annum
 - reduced group charges [xxx] per annum
 - combined retail business [xxx] per annum
 - wholesale operational savings [xxx] per annum
 - business rates [xxx] per annum
 - procurement and contracting [xxx] per annum
 - capital expenditure efficiencies [xxx] per annum.
- 3.25 These synergies will be delivered across the combined SWW and BW operations and represent [xxx] of the total expenditure (totex) of both companies.
- 3.26 The regulatory framework in which the two companies operate means that the parties will **automatically share wholesale merger synergies** which will result in reduced bills for both SWW and BW customers.
- 3.27 Mergers of retail activities are an inherent part of the future water regulatory incentive and market regime, and synergy savings will be passed back to customers in K7 as a result of lowering the average cost to serve and revenue allowances.
- 3.28 The net cost reduction resulting from the merger is anticipated **to lower customer bills across both areas by an average of up to c. [xxx] after 2020** as the reduced costs are passed back to customers. This only represents a mechanistic application of the current regulatory framework. Pennon anticipates that the wider service and market benefits will result in more dynamic impacts than this initial estimate.
- 3.29 The merger brings together two successful and customer oriented businesses that will provide **even better customer service as a combined entity** through opportunities for knowledge sharing. Both SWW (e.g. customer engagement) and BW (e.g. customer service) have achieved industry leading standards.
- 3.30 Whilst it is the current intention of Pennon to **merge BW's licence with SWW's**, there are no plans to change the BW name or remove local operational staff (particularly as SWW and BW are not contiguous and a local presence is essential for the efficient running of any water company).

- 3.31 The BW Customer View Group allows stakeholders and customer representatives to scrutinise performance of their local water company. As a result, **BW customers will not see any deterioration in the local service** they currently receive. On the contrary, the merger is likely to give rise to even higher customer service levels due to the opportunities for knowledge-sharing and greater innovation.
- 3.32 SWW developed WaterShare, a mechanism to share gains from company performance with customers in a transparent way. This includes aspects that are outside of formal regulatory mechanisms, with customer benefits arising through bill reductions or reinvestment agreed with an independent panel of customer and stakeholder representatives.
- 3.33 BW developed a similar framework, although the details were not codified in a specific way as per the SWW mechanism. Pennon is of the view that there are benefits to customers and stakeholders for BW to mirror the open and transparent principles of reporting performance in SWW's WaterShare mechanism.
- 3.34 Wholesale and retail tariffs will continue to be set separately during 2015-2020 for BW customers so that compliance with the 2014 Final Determination revenue controls can continue to be demonstrated. After 2020, Pennon will also offer **ongoing protection to BW customers to reflect the current bill differential to SWW of at least c. 35% - 40%**.

INVESTOR OUTCOMES AND BENEFITS

- 3.35 The merger provides a rare opportunity for equity investors to increase their investment in a regulated infrastructure business.
- 3.36 The merger sees the **combination of two efficient companies with a strong track record**. SWW was at the frontier of wholesale water cost efficiency at the 2014 Price Review (PR14).
- 3.37 Although BW has historically been efficient, it faces future cost challenges and was above Ofwat's cost threshold at PR14. BW also underperformed the 2014 Final Determination on operating costs and spent 8% more than Ofwat allowed for capital expenditure – this included significant additional capital investment as a result of exceptional water quality incidents.
- 3.38 SWW has developed a comprehensive systematised risk assessment process (as required under the amended Water Supply (Water Quality) Regulations 2000) over recent years for drinking water safety plans. The approach is strongly supported by the Drinking Water Inspectorate (DWI). For PR14, investment plans developed from the SWW process were commended as high quality by the DWI.
- 3.39 The merger presents an attractive opportunity to expand the wholesale capabilities of the combined business, driving synergistic and best practice operations. BW customers will benefit from a more resilient service as future challenges, such as

climate change, population growth and rising environmental standards are faced.

3.40 For both SWW and BW a merger represents a logical response in order to reduce the household retail cost to serve, aligning with the regulatory incentives in that area.

CONCLUSION

3.41 **Pennon considers the merger is in the best interests of customers, investors, stakeholders and the wider industry regulatory regime. The merger will not give rise to any prejudice in Ofwat's ability to make effective comparisons for the purposes of regulating water companies. The CMA should therefore clear this merger unconditionally.**

4. THE QUESTION OF PREJUDICE: THE CREATION OF A BETTER COMPARATOR

- 4.1 Schedule 4Z of the Water Industry Act 1991 (WIA) requires the CMA to assess whether the merger has prejudiced or may be expected to prejudice Ofwat's ability to make comparisons between water enterprises in carrying out its functions. If it finds no prejudice, the CMA must clear the merger unconditionally. If the CMA finds that a merger has prejudiced Ofwat's ability to make comparisons, it will then decide if any action is required to remedy the expected prejudice.
- 4.2 Pennon has already had good discussions with Ofwat and has reached significant areas of alignment on the issues raised by this merger.
- 4.3 **In this case, it is submitted that there is no prejudice as this merger produces net benefits to Ofwat's comparative regime by creating a better comparator.** SWW is already the leading company on wholesale costs. Pennon has identified a number of merger-specific, certain and long term sustainable synergy savings. With these synergy savings, the merged company will become even more efficient such that it will bring net benefits, overall, to Ofwat's ability to make comparisons, as Ofwat will be able to set more challenging efficiency targets for the rest of the industry.

WIDER INDUSTRY REGULATORY REGIME BENEFITS

- 4.4 Within the comparative regime, there are benefits from this merger, in terms of more challenging efficiency benchmarks, on both the wholesale cost and retail cost benchmarks. This will result in benefits to all water service customers in England and Wales in terms of reduced prices, compared to the case of no merger occurring.
- 4.5 Pennon believe there is a net benefit to all water customers in England and Wales which will be derived from the impact of the merger on the way Ofwat uses comparisons for regulatory purposes. Separately there are specific benefits for customers of the merging companies from the realisation of efficiencies and other benefits which will flow through to them, such as associated price reductions in the longer term.
- 4.6 The regulatory regime will benefit from the merger. Based on Oxera's calculations, the **merger is likely to give rise to a total net benefit of approximately [xxx] - [xxx]** as a result of:
- **the creation of a better wholesale cost comparator** which is more likely to be available and provide more efficiency challenge benchmark for the industry as a whole; and
 - **improving the industry benchmark on retail costs**, which will provide a more challenging efficiency benchmark for the industry as a whole.
- 4.7 Only [xxx] of the wholesale synergy savings set out in this plan are necessary to deliver the total net benefit shown above. As the full merger savings are delivered by 2019, there will be significant additional benefits:

- to customers of SWW and BW from lower costs in future plans (the above benefits the comparative regime, excluding the direct benefits to SWW and BW customers)
- from the regulatory mechanisms sharing these lower costs in the period to 2020 - 2025
- to customers of other water companies from lower wholesale cost benchmarks, as the wholesale cost benchmark continues to improve, as only a merger can deliver this range of synergy savings and other benefits.

4.8 There are **other additional benefits from the merger** which can also be quantified, which amount to [xxx]:

- potential targeted reduction in leakage due to the sharing of technology, experience and best practice – [xxx];
- 25 Ml/d of water trading through displacement – [xxx];
- household joint billing of water and wastewater retail services – [xxx]; and
- non-household retail market activity expected to include potential benefits from developer services improvements – [xxx].

4.9 Customer research already undertaken by ICS Consulting with customers from SWW, BW and other water companies indicates a **positive customer response to mergers**. Details of this research can be found in Annex G. The key findings from this research indicated that the majority of customers consider:

- mergers and acquisitions to be positive;
- any benefits (such as through synergies) should be shared with customers within the normal regulatory framework but could also be ‘recycled’ into improving services;
- mergers which lower bills are supported by over 85% of customers but there should be no detriment to existing or planned future service levels for either company;
- there should be transparent reporting of performance against original business plans; and
- 80% of customers support mergers if SCP returned to customers through lower bills.

4.10 The merger between SWW and BW is exactly the type of merger that the Cave Review¹ considered could be beneficial, noting that allowing small water company mergers can:

- deliver economies of scale that make the merged entity more efficient, given that data on water companies indicate that small water companies are on average less efficient than larger water companies: and

¹ Independent Review of Competition and Innovation in Water Market (2009) carried out by Professor Martin Cave, see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69462/cave-review-final-report.pdf

- lower financing costs for small water companies as the SCP would become redundant and the merged entity would have access to finance on more favourable terms available to larger water companies.
- 4.11 In addition, the Cave Review found that a merger that would reduce the number of comparators from 18 to 17, as would be the case as a result of the merger under consideration, would have limited adverse consequences.
- 4.12 Furthermore, the government acknowledges in its Explanatory Notes to the Water Act 2014 (WA 2014) that the mandatory reference for a Phase II review under the current regime dis-incentivises mergers between water companies which may create efficiencies for consumers. In accordance with this, the WA 2014 will amend the WIA 1991 to remove the automatic referral and to allow the CMA to decide on whether to refer a merger between two water companies or whether to accept undertakings to remedy the loss of a comparator in Phase I. These changes are designed to reduce the regulatory disincentive for companies to merge in appropriate cases.
- 4.13 The new regime will provide a greater role for Ofwat during the first stage (Phase I) of a merger inquiry and will require Ofwat to provide an opinion to the CMA on:
- the impact of a merger on their ability to make comparisons and relevant customer benefits; and
 - whether undertakings in lieu (UILs) would remedy, mitigate or prevent the prejudicial effect on their ability to make comparisons.
- 4.14 The changes made by the WA 2014 also require Ofwat to consult on and prepare a statement of methods, which sets out the criteria Ofwat will use to assess the impact on Ofwat's ability to make comparisons and the weighting applied to those criteria.
- 4.15 Ofwat are currently consulting on their statement of methods for considering mergers² under the new process. This submission has been prepared to take into account the proposals for the analysis that Ofwat set out in their consultation.
- 4.16 Pennon consider, and will demonstrate that, the proposed merger between SWW and BW does not prejudice Ofwat's ability to make comparisons and will provide significant benefits to customers. As a result, Pennon believe that if the new regime was in place then a mandatory automatic referral to Phase II would not have been required and that this merger would have been cleared in Phase I.

IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – OVERALL NET BENEFIT ([xxx])

- 4.17 Pennon have commissioned Oxera to undertake detailed analysis of the potential impact of the merger on Ofwat's ability to make comparisons, drawing on the Competition Commission's (CC) approach to the South Staffordshire (SST) and

² Ofwat Consultation (28 May 2015) Ofwat's approach to future mergers and statement of methods, http://www.ofwat.gov.uk/regulating/pap_con201505mergers.pdf

Cambridge (CAM) water merger, the recent Ofwat consultation on their approach to mergers and supporting Europe Economics analyses³.

- 4.18 Oxera's reports, which are summarised below, demonstrate that when all of these factors are considered, the merger will not give rise to any prejudice to the ability of Ofwat to make comparisons between water companies and is likely to give significant overall net benefits to the wider water regulatory regime.
- 4.19 Oxera have identified a potential quantifiable detriment in only one area, SIM, which itself is small, and which is an area which the impact is more transient, whereas, by contrast, Oxera have identified benefits in wholesale and retail benchmarks from the merger, which will be long lasting.
- 4.20 In section 8, Oxera conclude that over a thirty year period **across different market scenarios the merger results in overall benefit between [xxx] and [xxx], and between [xxx] and [xxx] over [xxx] years and over the more certain shorter time periods the impact of the merger appears relatively immaterial across the market scenarios.**
- 4.21 Particular areas where Ofwat has recently made use of comparisons include:
- **wholesale and retail cost modelling** in PR14 where Ofwat used information on individual water company costs to develop its cost models, cost benchmarks and cost allowances
 - **outcome delivery incentives (ODIs)** which were set at PR14 where, for five cross-company ODIs Ofwat used comparisons across water companies to identify upper quartile (UQ) performance and intervened to ensure that companies were only able to access financial rewards for genuinely stretching performance
 - **service incentive mechanism (SIM)** which uses qualitative and quantitative measures of customer satisfaction to financially reward or penalise companies based on their performance relative to the rest of the industry
 - **standards of board leadership, transparency and governance** across companies where Ofwat highlighted and shared best practice to encourage all companies to meet its principles in this area.
- 4.22 In Ofwat's Uplift Paper⁴, Ofwat considered the impact from the loss of a WoC through a merger as part of its determination on whether WoCs should be permitted an uplift on their cost of capital. This analysis included an assessment of the potential impacts in those areas of their price review where Ofwat rely on cross-company benchmarking, and also potential impacts in other areas. Ofwat concluded that there was insufficient evidence of an impact on customers as a result of the loss of a WoC through a merger

³ The Europe Economics paper is attached to Ofwat's consultation paper.

⁴ Ofwat's report on SWW *Final price control determination notice*: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital (page 48) (14 December 2014) http://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212swt.pdf (referred to as the "Uplift Paper")

in all areas except wholesale cost assessment and SIM, with some qualitative account taken of ODIs in three areas.

- 4.23 However, as discussed below, even in respect of wholesale cost assessment, SIM and ODIs, the analysis carried out by Ofwat in its Uplift Paper does not answer the question under current consideration by the CMA, namely what is the net effect of this merger on comparison. The Ofwat analysis only sought to consider one part of that calculus, namely the loss of a WoC, whereas the analysis undertaken by Oxera for the purposes of this transaction considers the impact of the merger as a whole (in other words, the loss of each of BW and SWW, but the gain of the new merged entity). For this reason, the analysis in the Ofwat Uplift Paper is a good starting point, but further work is required beyond that to determine the effect of the merger.

Impact of the merger on the precision of Ofwat wholesale cost models – no detriment

- 4.24 The loss of precision in Ofwat’s cost models is a potential issue that could arise from the loss of a comparator.
- 4.25 Analysis conducted by Oxera (see section 9) shows that the merger between BW and SWW has no material impact on the precision of Ofwat’s cost models, such that there is no prejudicial impact on Ofwat’s ability to use the UQ efficiency challenge.
- 4.26 Indeed, Ofwat agrees on this point. In PR14, Ofwat stated that with respect to the loss of a WoC, “the models continue to be fit for purpose to enable an UQ efficiency challenge; that is, there would be no need to set a less stringent efficiency challenge to compensate for any lack of precision in our models.”⁵
- 4.27 Overall, the evidence indicates that there is **no material impact on precision from the merger** and thus there is no prejudice. That is, **Ofwat can continue to use an upper quartile efficiency challenge, following this merger.**

Impact of the merger on Ofwat wholesale cost benchmark – benefit

- 4.28 In PR14, Ofwat undertook a total expenditure (totex) assessment and set companies cost allowance based on an UQ efficiency challenge. The merger of SWW and BW results in ‘losing’ SWW and BW and the creation of the new merged company. In section 10, Oxera examine the impact that the merger may have on Ofwat’s comparative regime through the wholesale cost benchmark challenge that Ofwat will be able to set in future reviews.
- 4.29 The overall results of this analysis using different approaches are presented in the table below:

⁵ Ofwat (2014), ‘Final price control determination notice: annex 3 – benefits assessment of an uplift on the cost of capital’, December, p. 8, available at: https://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212riskrewardbenefits.pdf

Approach	Impact at PR19 over 5 years	NPV impact over 30 years
Static approach	Benefit of £60m	–
Deterministic approach	–	Benefit of 46m or detriment of £1m depending on the probability assumptions. The average of these two impacts is a benefit of £23m
Dynamic approach ¹	–	Benefit of about £30m

4.30 This analysis suggests the merger results in a company that is likely to be a better comparator, benefiting Ofwat’s comparative efficiency regime, in terms of setting a more stringent efficiency challenge on the rest of the industry.

Impact of the merger on the retail average cost to serve – benefit

4.31 In Ofwat’s Uplift Paper⁶, Ofwat state “We confirm our view in the draft determinations that there is no benefit or dis-benefit from loss of WoCs to setting retail price controls.” Analysis undertaken by Oxera (see section 11) suggests there is a benefit.

4.32 In summary, Oxera’s analysis indicates that the merger of SWW and BW in a more challenging benchmark that will benefit the wider comparative efficiency regime on household retail, and thereby customers. This result holds even without considering any merger-specific savings. To the extent that the expected merger synergies would be included, the comparative benefit could be yet more significant.

4.33 In terms of the immediate impact of the merger at PR19, there could be a benefit of about [xxx] over [xxx]. Under a probabilistic approach, and where Ofwat’s expectations for cost convergence at future reviews are considered, there could be a benefit of about [xxx] (30-year net present value, NPV).

Impact of the merger on SIM – detriment ([xxx])

4.34 Ofwat consider that they can draw on comparators from other sectors to assess retail service quality and therefore water companies have relatively less value as comparators. Nevertheless, in the Uplift Paper Ofwat concluded that BW has benefits to customers as a SIM comparator.

4.35 With regards to the potential impact of the merger on the SIM, the quantitative analysis carried out by Oxera (see section 12) suggests that, if there is a detriment, it is, at most, between [xxx] and [xxx]. Oxera consider these figures to be an upper bound of the likely range for the following reasons:

- there is strong evidence that there has been (and will continue to be) significant convergence in companies’ SIM scores, this will limit the usefulness of the SIM going forward;

⁶ Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital (page 34)

- the difference between the maximum and minimum SIM scores in the industry is forecast to fall below a single point by the start of AMP7;
- the analysis to quantify any detriment is very sensitive to the assumptions made. For example, assuming some service improvements are achieved through the merger significantly reduces the detriment, and for some scenarios show a net benefit;
- Ofwat has already acknowledged that it could draw on comparators from other sectors to assess retail service quality and, therefore, water companies have relatively less value as comparators; and
- furthermore, as part of the final determinations, both BW and SWW will need to maintain separate reporting of their SIM scores during AMP6. This should further decrease the impact of a loss comparator over AMP6.

Impact of the merger on ODIs, PCs and service quality – no detriment

4.36 Ofwat conclude in the Uplift Paper⁷ that it was not possible to make a robust quantitative estimate of the likely impact on customers associated with the loss of a comparator for each of the ‘horizontal’ ODIs on which the consulted in their August draft determinations, due to the significant uncertainty about use of comparators for ODIs and the absence of sufficient track record associated with the impact of ODIs. However, Ofwat stated that it did take account of ODI performance of WoCs as part of their qualitative assessment. It noted, however, that such benefits were not large enough to change its conclusions that there will not be quantifiable costs from the loss of one or more WoCs in terms of PCs and ODIs.

4.37 Furthermore, in their Uplift Paper⁸, Ofwat stated: “In the absence of compelling evidence showing that WoCs inherently provide superior service quality, we conclude that it is unlikely that the level of service quality experienced by customers of WoCs would deteriorate following a merger with a WaSC. This means that there is unlikely to be a material detriment to customers in the area of service quality from the loss of one or more WoCs”.

4.38 Based on the findings of its analysis (see section 13), Oxera agrees with the view presented by Ofwat that there will not be quantifiable costs from the loss of one or more WoC in terms of PCs and ODIs. In particular:

- Ofwat has carried out effective comparisons with ten comparators for determining sewerage ODIs and PCs;
- few (only two) of the outcome areas require any comparative analysis for the setting of upper quartile targets;
- convergence implies that there is limited scope for further improvement in those few areas where comparisons were undertaken;

⁷ Policy chapter A7 Annex 3

⁸ Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital (page 41)

- it is questionable how much further improvement customers want to pay for – as the majority of ODIs are based on company-specific customer engagement, their customers have already indicated how they value service levels;
- local factors affect comparability as well as companies' ability to improve service levels. Moreover, BW may have unique factors that affect its relevance as a comparator such a highly seasonal population with a high peak average-demand ratio and around 80% of the supply to customers coming from only two water treatment works;
- performance against ODIs / PCs for both SWW and BW will need to be reported separately in order to monitor performance against commitments at final determinations. Given that there are no plans to remove local operational staff (particularly as SWW and BW are not contiguous and a local presence is essential for the efficient running of any water company), the separate reporting of PCs over AMP6 by SWW and BW should provide sufficiently independent data points for comparison purposes.

4.39 Therefore, Pennon concludes that there is no net impact of the SWW and BW merger on Ofwat's ability to make comparisons between water companies.

CONCLUSION ON PREJUDICE – NET BENEFIT

4.40 Taking into account synergies results in a benefit to the comparative regime, primarily through the creation of a more efficient comparator. As a conservative assumption, Pennon has only considered in the assessment [xxx] of the synergies identified in its business case. These synergy savings are a key driver of the net benefit resulting from the merger to the regime. Indeed, the results of the Oxera analysis show that:

- **over a thirty year period**, the overall impact of the merger is a benefit. Indeed, across different market scenarios **the merger results in overall benefit between [xxx] and [xxx]**
- **over ten year period**, the overall impact of the merger is a benefit. Indeed, across different market scenarios **the merger results in overall benefit between [xxx] and [xxx]**
- **over five year period**, the overall impact of the **merger appears relatively immaterial across the market scenarios**

4.41 In sections 8 - 13 below, the analysis shows that:

- the impact of this merger on the water industry customers in England and Wales is a benefit and this result is consistent over the different time horizon considered
- this result is driven in particular by the merger creating a better benchmark comparator both for retail and wholesale activities
- the merger is beneficial to the comparative regime, even without considering the potential direct benefits to the customers of the merging companies.

- 4.42 If one makes the assumption of a lack of synergy savings and therefore excludes the synergies from the calculation, then this would result in a smaller benefit of between [xxx] and [xxx] over 30 years in present-value terms. However, given that a key objective of the merger is the achievement of synergy savings, this scenario cannot be considered as plausible.
- 4.43 It therefore remains that the **overall impact of the merger is a net benefit to the comparative regime** in England and Wales.
- 4.44 **In conclusion, Pennon considers the merger is in the best interests of customers, investors, stakeholders and the wider industry regulatory regime. The merger will not give rise to any prejudice to Ofwat's ability to make effective comparisons for the purposes of regulating water companies. The CMA should therefore clear this merger unconditionally.**

5. BACKGROUND

INDUSTRY BACKGROUND

- 5.1 In 1989, the previously publicly-owned suppliers of water and sewerage services were privatised and became WaSCs. The WaSCs were appointed as undertakers for their regions. Statutory water companies, which had been privately owned, became WoCs and were subject to the same regulatory framework. Following this process, there were 10 WaSCs and 21 WoCs⁹.
- 5.2 At privatisation, each of the water companies were granted Conditions of Appointment (often referred to as the 'Licence'), which specifies the companies' obligations.
- 5.3 Today, there are still 10 WaSCs. The number of main WoCs has reduced to eight¹⁰, following a process of industry consolidation which has been linked to merger of company licences where those companies were already under the same ownership and the acquisition of one company by another and subsequent merger of the company licences.
- 5.4 Since privatisation, there have been a number of changes of ownership of the water companies and today only three companies (Severn Trent Water (SVT), Pennon (SWW) and United Utilities (UU)) are still listed as part of larger groups on the London Stock Exchange.
- 5.5 The total water services turnover of the water companies in 2014/15 was c. £6 billion, of which the WoCs accounted for c. £900 million¹¹.
- 5.6 The current WaSCs, their regions and parentage are:

Company	Approximate areas served	Parent
Anglian Water	East of England	Consortium consisting of Canada Pension Plan Investment Board, Colonial First State Global Asset Management, IFM Investors and 3i
Dŵr Cymru Welsh Water	Wales	Glas Cymru
Northumbrian Water	North East England	Cheung Kong Infrastructure Holdings
Severn Trent Water	West Midlands, East Midlands	None (listed on London Stock Exchange)
Southern Water	South East England	Greensands Holdings
South West Water	South West England	Pennon Group
Thames Water	Greater London, Thames Valley	Kemble Water Limited
United Utilities	North West England	None (listed on London Stock Exchange)
Wessex Water	South West England	YTL Corporation
Yorkshire Water	Yorkshire and the Humber	Kelda Group

⁹ http://www.ofwat.gov.uk/publications/commissioned/rpt_com_devwatindust270106.pdf

¹⁰ (1) Affinity Water (2) Bristol Water (3) Dee Valley (4) Portsmouth Water (5) Sembcorp Bournemouth (6) South East Water (7) South Staffordshire Water (8) Sutton and East Surrey Water

¹¹ Forecast based on Regulatory Account 2014, Table A5. Total Water turnover in 13/14 of £5.7bn of which WoC turnover £880m.

5.7 The current main WoCs, their regions and parentage are:

Company	Approximate areas served	Parent
Affinity Water	Central region: Amersham, Barnet, Beaconsfield, Bishop's Stortford, Harlow, Harrow, Hemel Hempstead, Letchworth, Luton, Saffron Walden, St Albans, Staines, Stevenage, Uxbridge, Watford, Welwyn Garden City, Woking East region: Brightlingsea, Clacton-on-Sea, Frinton-on-Sea, Harwich, Manningtree, Wivenhoe Southeast region: Dover, Folkestone, Hythe, Romney Marsh, Dungeness, Lydd	Morgan Stanley / M&G Investments
Bournemouth Water	Bournemouth, Christchurch, Lymington, Ringwood, Verwood, Wimborne Minster	Pennon Group
Bristol Water	Bristol, Burnham-on-Sea, Frome, Tetbury, Wells, Weston-super-Mare	Grupo Agbar
Cambridge Water	Cambridge	South Staffordshire Water
Dee Valley Water	Chester, Wrexham	independent
Essex and Suffolk Water	Essex region: Basildon, Brentwood, Chelmsford, Southend-on-Sea, Thurrock, Barking and Dagenham, Havering, Redbridge Suffolk region: Aldeburgh, Eye, Great Yarmouth, Lowestoft, Southwold	Northumbrian Water Group
Hartlepool Water	Hartlepool and surrounding area	Anglian Water
Portsmouth Water	Bognor Regis, Chichester, Fareham, Gosport, Havant, Hayling Island, Portsmouth	independent
South East Water	Eastern region: Ashford, Canterbury, Eastbourne, East Grinstead, Haywards Heath, Maidstone, Sevenoaks, Tonbridge, Royal Tunbridge Wells, Whitstable Western region: Aldershot, Basingstoke, Bracknell, Camberley, Maidenhead, Petersfield, Wokingham	Hastings Diversified Utilities Fund / Utilities Trust of Australia
South Staffordshire Water	Aldridge, Brownhills, Burton upon Trent, Cannock, Kinver, Lichfield, Rugeley, Sutton Coldfield, Tamworth, Uttoxeter, Walsall, West Bromwich	independent
Sutton and East Surrey Water	Cobham, Dorking, Horley, Leatherhead, Oxted, Redhill, Reigate, Sutton	Sumitomo Corporation

5.8 There are six other WoCs which are not used by Ofwat in their comparators.

5.9 Within its area of operation, each water company is a virtual monopoly and domestic customers have no choice of supplier. There are, however, five ways in which competition can be achieved under the current regulatory framework:

- **water supply licences** – from 1 December 2005 new water supply licensees were able to access a water undertaker's supply system for the purpose of

supplying non-household customers whose annual average consumption is greater than 50 megalitres (Ml) a year. There are approximately 2,200 customers in England falling within this category. The threshold was dropped to 5 Ml in 2012, and as a result approximately 26,000 customers in England are now able to source their water from a water supply licensee. Potential entrants need to obtain a licence from Ofwat. They can either apply for a 'retail' licence, which enables the holder to buy water wholesale from a water undertaker and sell to eligible customers; or a 'combined' licence, which allows the holder to introduce water into an existing water undertakers' supply system and sell it on to eligible customers. In both cases an access agreement is needed with the wholesaler to buy water from it or introduce water into its system.

- **new appointments and variations** – (also termed inset appointments) allow the existing regulated water or sewerage supplier to be replaced by another, at a specific site under certain criterion¹². Only a limited company or a statutory water company can become a water and / or sewerage undertaker. An inset appointee can serve its new customers either using its own resources or by requesting the use of the existing undertaker's assets.
- **cross-border supplies** – water undertakers have a duty to supply water for domestic customers outside their area provided that the customer is willing to pay the cost of making the connection to the undertaker's distribution network. This duty does not apply to customers who are eligible under the water supply licences regime. Owners of private sewers and drains have a similar entitlement to connect to the public sewer.
- **private supplies** – any person who owns a self-contained supply of water is entitled to supply water to others by agreement (subject to rules concerning water quality). This form of supply is not regulated by Ofwat.
- **providing new mains and service pipes** – developers are able to lay new water and sewerage mains and service pipes either directly or using their own contractors. If these assets are laid to water and sewerage undertakers' standards then the undertakers must take over responsibility for them.

5.10 The Open Water market reform programme will extend retail non-household competition to all suppliers from 1 April 2017. Further market and associated reforms for developer services and upstream will be introduced following the Water Act 2014.

5.11 There are also competitive opportunities in the market for the supply of services to companies in the form of contracting out of some or all of capital investment and operational activities. Outsourcing of activities is now commonplace within the water industry and includes the full range of functions required by companies including: consultancy services, engineering design, construction, civil engineering, mechanical and process engineering, asset refurbishment, network maintenance, customer services, vehicle leasing, information technology, laboratory services, debt recovery, research and development and facilities management.

¹² <https://www.ofwat.gov.uk/competition/inset/>

- 5.12 In Scotland, since 1 April 2008 all non-household customers have had a choice of retail supplier. These suppliers purchase wholesale services from Scottish Water which owns the network of water and sewerage pipes and acts as the wholesale supplier. There is no eligibility threshold and competition is possible for both water and sewerage services. Scottish Water, the only incumbent operator, has been legally separated from its retail arm which is now called Business Stream. Business Stream is one of fourteen different suppliers in Scotland¹³.
- 5.13 Although there had not been much switching by companies to new suppliers at the start of market opening, increased market entry has seen switching rates increase. Business Stream also operates in England and has recently won contracts for retail services to House of Fraser and Bernard Matthews Farms¹⁴.

THE EXISTING REGULATORY FRAMEWORK

Key legislation

- 5.14 The main Acts that govern the regulation of the water industry are the Water Act 1989, the Water Industry Act 1991, Water Act 2003 and the Water Act 2014.
- 5.15 The Water Act 1989 established the current structure of the water and waste water industry in England and Wales. It also created a new quality regulation regime for the industry, operated by the National Rivers Authority (now part of the Environment Agency (EA)) and the DWI.
- 5.16 The WIA 1991 set out the powers and duties of the WaSCs, thus replacing those set out in the Water Act 1989, and defined the powers of the Director General of Water Services (now Water Services Regulatory Authority, Ofwat).
- 5.17 The Water Act 2003 made wide-ranging changes to the WIA and the regulatory framework. These included the introduction of further measures to encourage competition to supply high-volume water users.
- 5.18 Other Acts that have significantly modified the regulatory framework include the Competition and Service (Utilities) Act 1992 (which increased the limited opportunities for competition in the industry), the Environment Act 1995, the Water Industry Act 1999 and the Flood and Water Management Act 2010.
- 5.19 Many of the UK's water quality and environmental standards derive from EU directives. The EU Drinking Water Directive 1998 sets standards for the quality of water intended for human consumption. The overall framework for the use and protection of water resources is set out in the EU Surface Water Abstraction Directive, the EU Groundwater Directive and the EU Water Framework Directive. Within England and Wales, these quality requirements are mainly enforced by the EA and the DWI.

¹³ <http://www.scotlandontap.gov.uk/suppliers/>

¹⁴ www.business-stream.co.uk See press releases.

5.20 The final key legislative element is the Water Act 2014 which received Royal Assent in May 2014. This introduces markets for non-household customers in England from 2017 as well as upstream licence reforms. Such reforms are discussed in more detail below.

THE ROLES OF KEY REGULATORY BODIES

5.21 Defra has overall responsibility for the legal and policy framework for the water industry in England. It sets standards, appoints the board members of Ofwat and issues special permits, such as drought orders.

5.22 The water industry is subject to tripartite regulation. The independent regulator, Ofwat, is responsible for economic regulation; the DWI is responsible for the quality of drinking water; and the EA is responsible for environmental issues.

THE ROLE OF WATER SERVICE REGULATORY AUTHORITY, OFWAT

5.23 Ofwat is the economic regulator of the water industry. It succeeded the Director General of Water Services on 1 April 2006. Ofwat's duties are set out in the Water Industry Act 1991 as amended by the Water Act 2003 and 2014. It is a non-ministerial department of government.

5.24 Ofwat's primary duties are to act in the way it considers best to:¹⁵

- protect the interests of consumers, wherever appropriate by promoting effective competition
- secure that the functions of each undertaker (that is, water company) are properly carried out and that they are able to finance their functions, in particular by securing reasonable returns on their capital
- secure that companies with water supply licences (those selling water to large business customers) properly carry out their functions
- (in relation to English water companies) secure the long-term resilience of water supply and wastewater systems and that undertakers (that is, water companies) take steps to enable them, in the long term, to meet the need for water supplies and wastewater services¹⁶.

5.25 In carrying out these duties, Ofwat has secondary duties to:

- promote economy and efficiency
- secure that no undue preference or discrimination is shown by water companies in fixing charges
- secure that consumers' interests are protected where water companies sell land
- ensure that transactions with associated companies are carried out at arm's length

¹⁵ <http://ofwat.gov.uk/aboutofwat/duties/>

¹⁶ New primary duty added by the Water Act 2014

- ensure that each water company maintains its accounts in a suitable form
- contribute to the achievement of sustainable development
- have regard to the principles of best regulatory practice
- contribute towards attaining any environmental and social policies set out in guidance from the Secretary of State.

5.26 A key function of Ofwat is the monitoring of compliance of the water companies with their licence obligations and revising the licences as circumstances change. Every five years Ofwat sets price limits which determine the increases that water companies can make to their charges. The most recent price controls were set in 2014 for the period from 2015 to 2020. This is known as PR14 because the final determinations were made in 2014, ahead of taking effect from 1 April 2015. Ofwat also monitors the performance of the water companies to ensure that they deliver the required services and improvements in quality.

THE ROLE OF THE ENVIRONMENT AGENCY

5.27 The EA is a non-departmental public body sponsored by Defra. It was established under the Environment Act 1995 and consolidated the activities of several environmental regulators. It is the public body with the main responsibility for protecting and improving the environment of England and the principal adviser to the government on environmental matters.

5.28 The EA has a duty to secure the proper and efficient use of water resources in England. The principal means of securing this is through licensing the abstraction of groundwater and river water. The EA aims to use the licensing system to achieve a balance between the requirements of abstractors and adequate protection of the environment. The Water Act 2003 introduced major changes to abstraction licensing. These included time limits for new licences, greater flexibility to raise or lower licensing thresholds and the ability to revoke licences that cause serious environmental damage. Water companies are also required to prepare drought plans and 25-year water resource management plans.

5.29 This includes responsibilities relating to drought management. It also has duties relating to sewerage services, which are not described in this document. In addition the EA is an enforcement body for the Water Framework Directive (WFD) and has river basin management plan (RBMP) responsibilities.

THE ROLE OF THE DRINKING WATER INSPECTORATE

5.30 DWI is part of Defra, their main task is to check that water companies in England and Wales supply water that is safe to drink and meet standards set in water quality regulations. Water companies have a duty under the WIA 1991 to supply water that is wholesome at the point of supply.

- 5.31 'Wholesomeness' is defined by reference to the standards and requirements set out in the Water Supply (Water Quality) Regulations 2000 which incorporate the requirements of the EU Drinking Water Directive.
- 5.32 The DWI's other tasks include: carrying out technical audits and inspections of water companies; investigating incidents that adversely affect drinking water quality; preparing cases for prosecution when water unfit for human consumption has been supplied; providing technical and scientific advice to Ministers and officials of Defra on drinking water quality issues; and providing authoritative guidance on analytical methods used in monitoring drinking water quality.

THE ROLE OF THE CONSUMER COUNCIL FOR WATER

- 5.33 The Water Act 2003 established the Consumer Council for Water (CCWater). It came into effect on 1 October 2005 replacing WaterVoice, an autonomous division of Ofwat, which had in turn replaced Ofwat's regional customer service committees in 2002. CCWater is an independent non-departmental public body, sponsored by Defra and the Welsh Government.
- 5.34 Under the Water Act 2003 it is charged with handling complaints from customers and representing customers' interests in the policymaking process.
- 5.35 CCWater was actively involved in advocating customers' views during the PR14 process. CCWater often took a leading role in chairing of the Customer Challenge Groups which were used to discuss investment priorities in the plans developed by water and sewerage companies. The voice of the customer was more central to PR14 than in previous price reviews since privatisation.

THE ROLE OF THE CMA

- 5.36 Under section 32 of the WIA 1991 (as amended by the Act and the Water Act 2003) a merger involving any two water companies in England and Wales must be referred for a Phase II review to the CMA where the turnover of each of the water companies to be merged exceeds £10 million. This is referred to as the special water merger regime. The WA 2014 put in place measures to reform the special merger regime. This is discussed below.

REFORM OF THE WATER SECTOR REGIME

Water for Life

- 5.37 In 2008 Defra commissioned an independent review of competition and innovation in water markets undertaken by Professor Martin Cave¹⁷. The review's final report, published in April 2009, proposed among other recommendations a number of changes to the way the water and sewerage industry is regulated in order to enable the development of competition both upstream and in the retail market.

¹⁷ See Footnote 1.

5.38 The Government considered these recommendations and published its response in a white paper published in December 2011: Water for Life (the White Paper). The White Paper stated that a draft Water Bill would be published for pre-legislative scrutiny in early 2012 and that a Water Bill would be introduced as soon as Parliamentary time allowed.

5.39 Against a backdrop of anticipated increasing pressure on the supply / demand balance due to a combination of climate change, growing population and rising household demand in parts of the country, the White Paper set out plans to reform the supply licence regime to enable entry at different points in the value chain and to reform the special water merger regime in order to loosen it.

REFORM OF THE SUPPLY LICENCE REGIME

5.40 The Water White Paper described changes to the supply licence regime, following which new entrants would have a range of possible ways to enter the industry at different points in the value chain. The changes would also strengthen the role of the other regulators to approve new entrants before Ofwat issues a relevant water supply licence. The DWI would be consulted on the suitability of new entrants in the water services market to hold supply licences or inset appointments, whilst the EA would similarly be consulted on the suitability of new entrants in the sewerage market. A range of unbundled licences was proposed, including:

- **upstream licences** – which would enable a new entrant to provide a range of different services including water or waste water treatment and storage services
- **network licences** – to enable new entrants to own or operate their own infrastructure (mains, pipes, storage and treatment)
- **retail licences** – the White Paper stated that the government had decided not to require water companies to separate or sell their retail businesses but instead considers that all business customers in England should be able to choose both their water supplier and their sewerage supplier. The government also encouraged new entrants in the retail segment by removing the requirement for retail licensees to set up ring-fenced limited companies
- **self-supply licences** – enabling suitably qualified customers to purchase water at wholesale prices without using a retail licence.

5.41 To give transparency in wholesale pricing and enable unbundled licences to operate and promote water trading, the reform of wholesale access prices was also highlighted. To date, these have been based on the 'costs principle' using a retail minus approach. This, however, has been considered a potential barrier to entry.

REFORM OF THE SPECIAL WATER MERGER REGIME

5.42 Since 2004 any merger between two or more appointed companies, where one or both companies has an annual regulated turnover that exceeds £10 million, must be referred for an in-depth Phase II inquiry. This is termed the 'special merger regime'.

5.43 In its Water for Life White Paper¹⁸, the Government proposed changes to the special merger regime for the water sector. The White Paper stated that:

- mergers can be a strong driver for improving the efficiency of companies, leading to improved service and lower costs that can be passed on to customers
- requiring that all water industry mergers to be subject to an (expensive) in-depth investigation reduced the likelihood of potential mergers between water companies and the scope for water companies to be taken over by more efficient operators and any resulting benefits.

5.44 The White Paper planned to use the Water Bill to introduce changes to the special merger regime to improve efficiency including the potential to increase the annual regulated turnover threshold from £10m to £70m.

WATER ACT 2014

5.45 The Water Bill was presented to parliament and received Royal Assent in May 2014 entering the statute book as the WA 2014. The Act put in place the measures outlined in the Water White Paper including the reform of the supply licence regime and the special merger regime and the direction of travel outlined in the Cave review.

5.46 With regard to water supply licensing the WA 2014 included measures to enable businesses to supply new sources of water or sewerage treatment services through the provision of separate upstream licences. It also enabled competition for all non-household customers in England to switch their water and sewerage retail supplier from 2017. It also put in place measures to remove the cost principle.

5.47 With regard to the special merger regime, the WA 2014 provides for the amendment of the Water Industry Act to allow the CMA to determine in Phase I of a merger inquiry whether to make a merger reference to Phase II, including whether to accept undertakings to compensate for the loss of a comparator in lieu of a reference. This will mean that not all qualifying mergers will need to be referred to the in-depth Phase II CMA inquiry group-led review.

5.48 The revised approach to mergers means the CMA can conclude that a Phase II review is not necessary if:

- the merger arrangements are not sufficiently far advanced, or not sufficiently likely to proceed to justify making a reference
- the merger is not likely to prejudice Ofwat's ability, in carrying out its functions by virtue of the WIA 1991, to make comparisons between water enterprises
- the merger is likely to prejudice that ability, but the prejudice in question is outweighed by relevant customer benefits relating to the merger
- there are appropriate Undertakings in Lieu from the merger parties which remedy, mitigate or prevent the prejudicial effect on Ofwat's ability to make

¹⁸ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228861/8230.pdf (December 2011).

comparisons between water enterprises resulting from the merger¹⁹.

5.49 The WA 2014 changes also require the CMA to keep under review the £10 million turnover threshold and to advise the Secretary of State from time to time whether this threshold is still appropriate.

5.50 The WA 2014 also placed a new duty on Ofwat with regard to securing the long-term resilience of water and wastewater supply in England.

OFWAT'S PROGRAMME OF REFORM

5.51 The WA 2014 was a key milestone in the reform of the water sector and leading up to this has been a programme of parallel regulatory reform. Following on from the Cave Review, in 2009 Ofwat started a review of the way it regulated the water and sewerage sectors.

5.52 Ofwat's review has been wide-ranging. It focused in particular on the external challenges facing the sector (climate change, affordability, rising environmental standards, rising consumer expectations, population growth and lifestyle changes), the complexity of regulation (including the incentive mechanisms that Ofwat uses) and the burden of regulation on the water companies' management.

5.53 Ofwat has been considering the aspects of the regulatory regime that work well, as well as changes needed to help address the challenges of the future. It has been considering how the regulatory regime might evolve to:

- focus regulation and enforcement on the biggest areas of risk to consumers in a proportionate and targeted manner
- make evolutionary changes to the way it sets price limits
- empower customers (through their representatives) to make the best choices in terms of the services they receive from their local water company
- make the best use of market mechanisms, including exploring the options for making water trading easier and enabling new companies to enter the market and offer services
- make the most of the tools that are available to Ofwat.

5.54 PR14 was a key milestone in the reform process. It delivered the rollout of risk based regulation on business plans, the use of Customer Challenge Groups to empower customers to make choices on the service they receive and it implemented four separate binding price controls – wholesale water, wholesale wastewater, retail household and retail non-household. The latter being a pre-requisite to enable the reforms in the WA 2014 such as non-household competition.

5.55 PR14 also saw the implementation of new incentives around water trading and the requirement for water companies to publish water resource requirements through their

¹⁹ http://www.ofwat.gov.uk/regulating/pap_con201505mergers.pdf?download=Download

Water Resource Management Plans to facilitate better use of a scarce resource.

5.56 For further detail on Ofwat's reforms see Annex I.

THE MERGING PARTIES

Parent company and shareholders

5.57 Pennon has acquired 100% of the issued share capital of BWIL and its subsidiaries from Sembcorp Holdings Limited, a Singapore based private equity company.

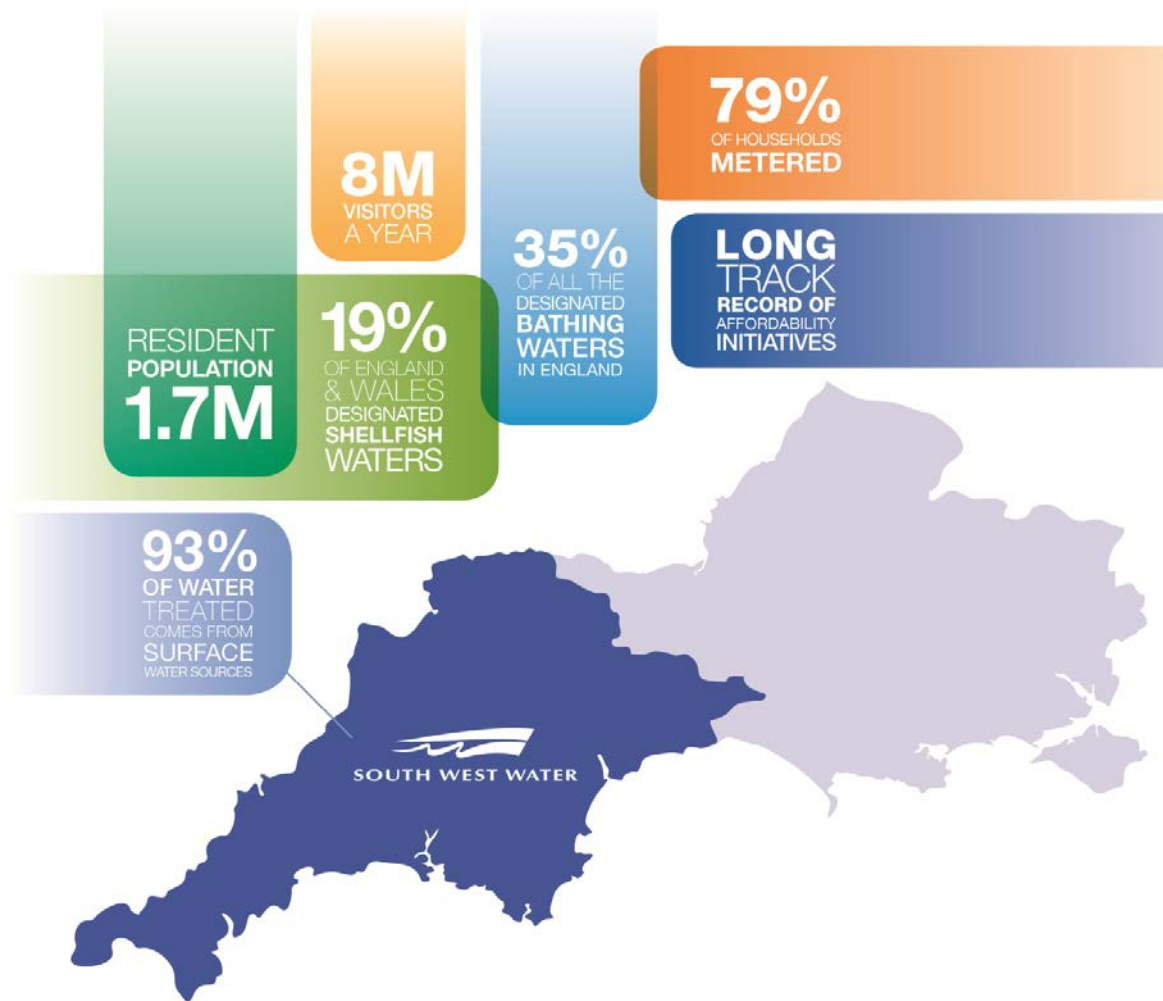
5.58 Pennon is a large FTSE 250 company which operates and invests in utility infrastructure businesses. Pennon has around £5.0 billion assets and employs around 4,500 people. The Group is committed to sustainable development, enhancing the environment, providing high quality customer services.

5.59 The Group has two principal subsidiaries SWW and Viridor Waste Management Limited ("Viridor"). SWW provides water and sewerage services in Devon, Cornwall and parts of Dorset and Somerset and Viridor is one of the UK's leading recycling, renewable energy and waste management businesses. Operationally, the Viridor business is not affected by this merger, other than at Group level. An organisational Structure chart showing Pennon's company structure both pre and post-merger was submitted as part of the initial factual information response dated 15 June.

South West Water

5.60 SWW is a wholly owned subsidiary of Pennon and provides water and sewerage services to 700,000 households and 70,000 businesses in Devon, Cornwall and parts of Dorset and Somerset.

5.61 As well as the regulated undertaking, SWW has non-regulated operations which includes Source for Business Limited, a water services retailer with a licence to operate in Scotland as well as England, as well as providing on site water efficiency and waste management services for business customers.



5.62 Since 1989, SWW has invested nearly £6bn to maintain and improve the water and wastewater services on which livelihoods and businesses in the region depend.

5.63 SWW has a strong track record of regulatory, operational and financial performance, perhaps best indicated by being the only water and sewerage company to achieve “fast-tracked” enhanced status from Ofwat at the recent price review. Key features of this achievement include:

- acceptance by Ofwat of the SWW business plan in the round
- cost of capital 0.1% higher than a non fast-tracked company at 3.85%
- £11m enhanced reward added to the RCV
- efficient wholesale cost assessment – totex menu position of 91.5% water and 99.5% wastewater
- 5% enhancement to totex menu sharing rate for enhanced status.

5.64 The business plan was strongly supported by customers and stakeholders, reflecting a fair balance of innovation, investment in services and a stable / low risk approach to financing that appropriately shares performance between investor returns and customer benefits.

- 5.65 As Ofwat noted, “the Business Plan stood apart from the other companies” and “we have had to make minimal changes to the company’s plan to protect customer’s interests and act in line with our other statutory duties.”
- 5.66 SWW is proposing to work in partnership with other parties to pursue low-cost sustainable solutions for improving water quality, managing flood risk and improving the resilience of its service. Its Upstream Thinking programme, for example, involved working with charitable organisations, land owners and the EA to continue its award winning work on improving catchments that are designated Drinking Water Protection Areas. Its Downstream Thinking programme involves working with parties such as developers and local flood authorities on a range of drainage management initiatives, including those focusing on sustainable drainage.
- 5.67 SWW is also proposing to deliver its proposed improvements to its retail service at no additional cost to its customers and absorb cost increases through efficiency savings.
- 5.68 SWW continues its track record of efficiency and outperformance with robust operational delivery, high standards of customer service and strong financial performance. The company has successfully delivered the 2010-2015 regulatory contract.
- 5.69 Throughout the 2010-2015 regulatory period, SWW has achieved robust operational performance – with improving standards of service, delivering environmental benefits and maintaining strong financial performance. This allows early benefits to be delivered to customers, including a price freeze in 2014/15 to allow a smooth transition of bills into 2015-2020.
- 5.70 Transparency for customers and stakeholders of this company ethos will be extended for 2015-20 with the introduction of WaterShare, which allows for on-going scrutiny of company performance by stakeholders and customer representatives so that gains can be fairly shared through bill reductions or accelerated investment in services as they arise, particularly where these are not captured already in the formal regulatory mechanisms.
- 5.71 The award of enhanced status to SWW’s Business Plan also enabled a swift and smooth transition into the next regulatory period. Delivery of key projects – including those which improve the region’s bathing waters and water quality – have been advanced into 2014/15 delivering benefits for customers and investors alike. Accelerating projects will also assist in delivering outcomes and cost efficiencies in a timely fashion.

Bournemouth Water Investments Limited (BWIL)

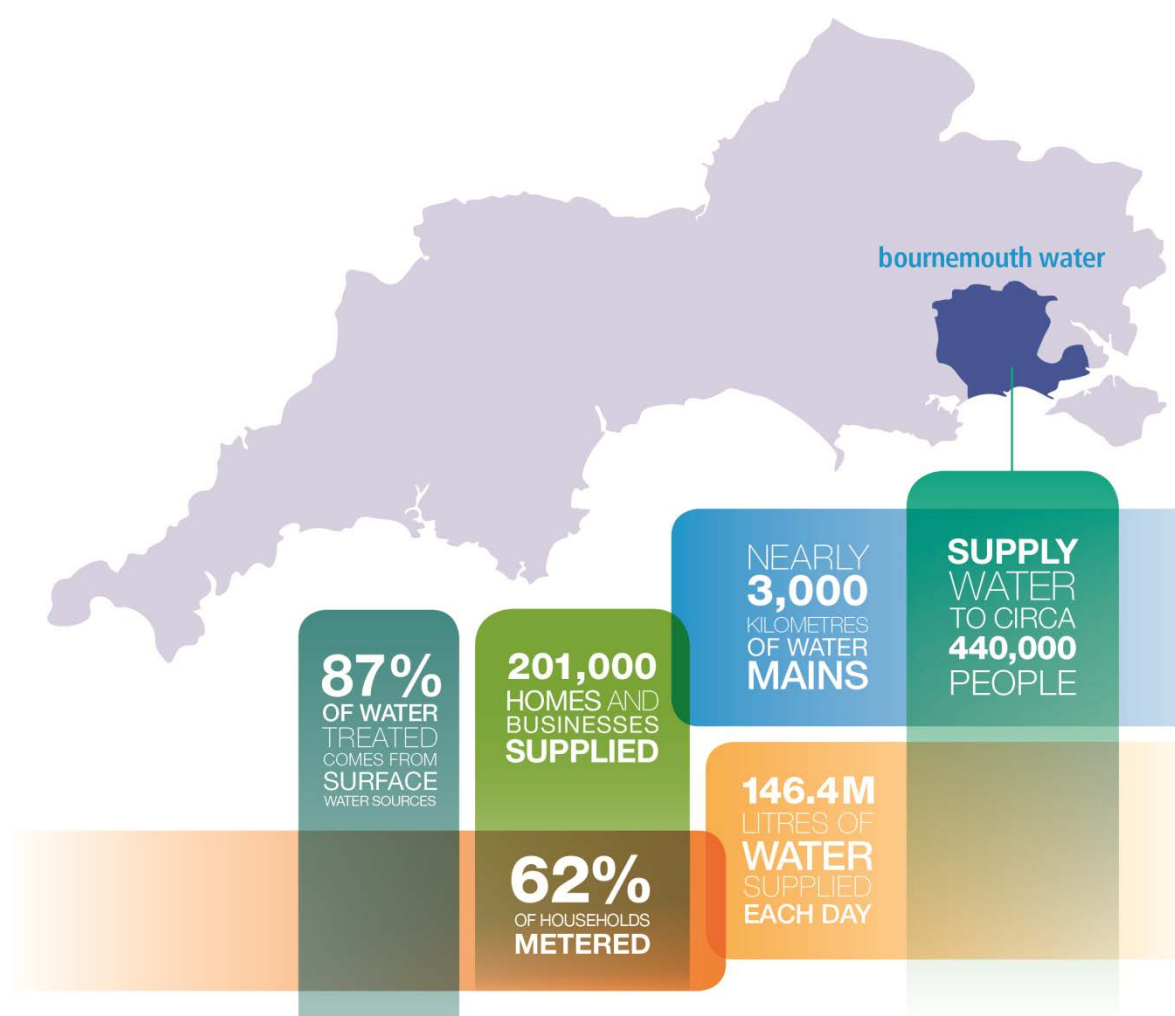
- 5.72 BWIL (formerly known as Sembcorp Bournemouth Water Limited) was acquired by Pennon from Sembcorp Bournemouth Water Limited, a Singapore based private equity company on 16 April 2015. BWIL changed its name on 16 April 2015 to remove all reference to “Sembcorp”, given the change in ownership. A table showing companies in the BW structure, and setting out details of recent name changes was provided as part of the initial factual information submission.

5.73 BWIL is the holding company for BW and includes two non-regulated businesses. Aquacare Limited provides water hygiene and treatment services to local authorities, social housing and industry. Avon Valley Water Limited provides water retail and private network services to industrial customers under its own Water Supply Licence.

Bournemouth Water (BW)

5.74 BW is the wholly owned subsidiary of BWIL. The company does not provide sewerage services and is a water only company.

5.75 BW supplies drinking water to 440,000 people from a base in Bournemouth. Its area covers parts of Dorset, Hampshire and Wiltshire. Wastewater services in the area are provided by Wessex Water and Southern Water. Customers receive separate bills for water and wastewater services. The wastewater services are not affected by this merger (and Pennon has not acquired any interest in those businesses). BW does not provide sewerage services.



5.76 In 1989 Bournemouth Water and West Hampshire Water came under a joint majority shareholding through Biwater, a British multi-national water engineering group, to take advantage of new opportunities from the privatisation of the former Water Authorities in 1989.

- 5.77 In 1994 Bournemouth and District and West Hampshire Water was formed as the two companies merged. In 2000 Bournemouth and West Hampshire Water subsequently became the main part of Cascad, initially a joint venture between Biwater and Nuon, a Dutch utility company, finally becoming 100% owned by Biwater in 2008.
- 5.78 In 2010 Sempcorp Utilities Pte, a wholly-owned subsidiary of Singapore based Sembcorp Industries, acquired Bournemouth and West Hampshire Water. In 2011 Bournemouth and West Hampshire Water Plc changed its registered name and status to Sembcorp Bournemouth Water Limited.
- 5.79 BW delivers its services efficiently and to high standards, and is one of the best-performing water companies across a range of indicators including:
- **value for money** – average water bill in 2013/14 is 17% below the industry average
 - **customer service** – ranked equal top using the industry’s Service Incentive Mechanism (SIM) over the two-year period 2011/12 to 2012/13; and received the Customer Service Excellence Award for the 13th consecutive year
 - **reliability of service** – number and duration of interruptions is one of the lowest in the industry, with 1% of customers experiencing a loss of supply for more than three hours in 2012/13
 - **costs** – retail and customer debt costs are amongst the lowest in the industry, with bad debt averaging £4.52 per customer per year over the last three years. Wholesale costs are also low.
- 5.80 BW will continue to provide a ‘best in class’ service to our customers. BW regard this as particularly important as customers do not have a choice in respect of their water supply. BW’s commitment is to improve the service and reduce base costs even further, achieving more at a lower cost, which will benefit BW customers.

6. MERGER TRANSACTION AND RATIONALE

STRUCTURE OF THE ACQUISITION

- 6.1 Pennon acquired 100% of the issued share capital of BWIL including its non-regulated and regulated subsidiaries from Sembcorp Holdings Limited for a cash consideration of £100.3 million. As part of the Acquisition £86.9 million of external net debt and debt like items have been assumed by Pennon.
- 6.2 BWIL is the holding company for BW and includes a developing non-regulated business providing a platform for retail expansion and the provision of value added services to customers. For the year ended 31 December 2014, the acquired businesses had combined revenues of £49.2 million, operating profits of £15.3m and profit before tax of £10.2m.

RATIONALE

- 6.3 BW is a regulated water only company serving a population of approximately 440,000 in the Bournemouth region, with a Regulatory Capital Value (RCV) of £148.8m as at 31 March 2014.
- 6.4 BW is a profitable business and one of the highest performing water only companies in the UK across a range of indicators with outstanding customer service reflected in its SIM scores.
- 6.5 The Pennon Board considers the acquisition to be highly complementary to SWW and it believes that it presents an attractive opportunity to expand SWW's wholesale capabilities whilst driving synergistic and best practice operations.
- 6.6 The acquisition forms part of Pennon's broader strategy to re-organise SWW's operations ahead of market liberalisation and prepare for the statutory reform of the non-household retail market from 2017 and is expected to deliver significant benefits to both customers and shareholders through a combined retail business structure.
- 6.7 The acquisition is expected to provide an incremental 5% growth in SWW's RCV and to modestly enhance earnings per share (before deferred tax) following integration, which is expected to commence following any CMA approval.
- 6.8 Commenting on the Acquisition, Chris Loughlin, Executive Director of Pennon and Chief Executive of SWW said "Bournemouth is a top-performing water company and is an excellent business fit with SWW's existing operations. The combined business will provide an enhanced platform for innovation and growth ahead of market liberalisation in 2017 and will better serve both Bournemouth and the South West, delivering tangible benefits to customers and shareholders."

INTEGRATION PLANS

- 6.9 Pennon has acquired BWIL and BW as part of its targeted acquisition strategy and preparations for change in the UK water sector, including non-household retail market opening in 2017.

- 6.10 The intention of Pennon is to operationally merge BW retail non-household and household with SWW retail activities. The combined incumbent non-household retail business will be legally separated for the purposes of retail market development.
- 6.11 Wholesale water activities will be organised centrally, using SWW innovations and new technology. The merger process will act as an enabler for retail and upstream market reform. Resilience of services will be improved across a wider area than covered by the individual undertakings.
- 6.12 Following regulatory approval, a new licence structure for the combined wholesale / retail activities will be put in place following discussion with Ofwat. This will provide the opportunity for new forms of water company Licences to be considered.
- 6.13 Pennon considers that this approach would deliver savings compared to maintaining separate licences. Pennon anticipate the merger will deliver [xxx] annual operating cost synergies, with savings being mainly achieved across both companies and throughout different parts of the value chain. This will result in lower bills for customers of SWW and BW.
- 6.14 Pennon will be transparent about the progress made in delivering value from the acquisition and use the existing SWW WaterShare framework in both SWW and BW to demonstrate this. This will ensure ongoing engagement with both communities and link to the development of future plans.
- 6.15 Existing customer bills and service level commitments will be delivered as a minimum. Specific benefits for BW customers will include a bill reduction to reflect the pass back of the small company premium from 2016/17.

JURISDICTION / CMA TEST

Phase I mandatory reference

- 6.16 The CMA is subject to a duty to refer mergers between two or more water enterprises to its chair for a Phase II review if the CMA believes that it is or may be the case:
- that arrangements are in progress, which, if carried into effect, will result in a merger of any two or more water enterprises
 - that such a merger has taken place.
- 6.17 The duty applies if the value of the turnover of the water enterprise being taken over or the value of the turnover of each of the water enterprises belonging to the person making the takeover does not or would not exceed £10 million.²⁰

²⁰ Section 22(1) WIA as substituted by section 70 of the 2002 Act.

CMA duties at Phase II

6.18 Schedule 4ZA of the WIA 1991 provides that (equivalent to section 35(1) of the Enterprise Act 2002, as modified), on a reference of a completed water merger, the CMA must first consider:

- whether a water merger has taken place
- if so, whether that merger has prejudiced, or may be expected to prejudice, the ability of Ofwat, in carrying out its functions, to make comparisons between different water enterprises.

6.19 The CMA will assess whether the impact of the particular merger on Ofwat's ability to make comparisons is, or may be expected to be, adverse and significant enough to amount to prejudice.²¹

6.20 It is clear that a detriment in one particular area of comparison is not in itself necessarily significant enough to amount to prejudice overall. In SST / CAM, the CC identified a detriment of c. £4m - £6 m NPV in terms of opex efficiency, but nevertheless concluded that, overall, the impact of the merger was not 'sufficiently adverse and significant to amount to prejudice under the Act'. This point is particularly important in a scenario in which the merger may (as here) result in comparative benefit in some areas.

6.21 If the CMA finds that a merger has prejudiced or may be expected to prejudice Ofwat's ability to make comparisons, it will then decide if any action is required to remedy, mitigate or prevent the prejudice, or any adverse effect which has resulted from, or may be expected to result from, the prejudice. In doing so, it may have regard to the effect of such action on any relevant customer benefits in relation to the merger provided that a consideration of those benefits would not prevent a solution to the prejudice concerned, or the benefits which have accrued, or may be expected to accrue, are substantially more important than the prejudice concerned.²²

6.22 Relevant customer benefits are benefits:

- to "relevant customers", which are defined as customers of the merging parties at any point in the chain of production and distribution and are therefore not limited to final consumers and include future customers
- in the form of lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (not just the relevant water markets); and / or greater innovation in relation to such goods or services
- where the CMA believes that the benefit (a) has accrued as a result of the merger concerned or may be expected to accrue within a reasonable period as a result of the merger concerned; and (b) was, or is, unlikely to accrue without the merger concerned or a similar prejudice to the ability of Ofwat to make comparisons.

²¹ Competition Commission, *Water Merger References: Competition Commission Guidelines* dated December 2004 ("CMA Guidance"), at 2.3 and *South Staffordshire* at paragraph 18

²² See paragraph 4(2) of Schedule 4Z WIA

7. BENEFITS AND SYNERGIES

- 7.1 As set out above, only if the CMA finds that a merger has prejudiced Ofwat’s ability to make comparisons, it must then decide if any action is required to remedy the expected prejudice, which may include a consideration of the effect of any remedies on any relevant customer benefits.
- 7.2 As previously summarised, Pennon believe there is a benefit (and no overall detriment) to Ofwat of combining the high performing and efficient SWW and BW for comparison purposes. Therefore, Pennon submits that there is no need for the CMA to come to a view on relevant customer benefits. However, for completeness it is noted that in addition to the regulatory benefits arising from the merger highlighted above, the merger also results in customer benefits which could not be achieved by SWW and BW on a stand-alone basis.
- 7.3 For the purposes of the WIA, relevant customer benefits are those in the form of “lower prices, higher quality or... greater innovation”. The benefits resulting from this merger take all of these forms as detailed below:



- 7.4 The majority of these savings are dependent on the combination of SWW and BW licences following completion of the CMA's review.

LOWER CUSTOMER BILLS

- 7.5 The merger will give rise to significant efficiency benefits, the **removal of the small company premium** from 2016/17, which is proposed reflecting that the new merged entity would not be subject to this uplift (consistent with customer research into the value customers placed on the SCP), and **the reduction of corporate costs of operating two separate companies**, which will be available to be shared with the combined entity's customers at the 2019 Price Review (PR19) **resulting in lower bills customer bills**.
- 7.6 The operational merger of SWW and BW will result in lower costs across both companies. These cost synergies can only be delivered by the merger and will be delivered over the next two to three years and focused in the following areas:
- sale of land and surplus operational properties c. [xxx]
 - reduced overhead [xxx] per annum
 - reduced group charges [xxx] per annum
 - combined retail business [xxx] per annum
 - wholesale operational savings [xxx] per annum
 - business rates c. [xxx] per annum
 - procurement and contracting [xxx] per annum
 - capital expenditure efficiencies [xxx] per annum.

Sale of land and surplus operational properties – [xxx]

- 7.7 The securitised financing arrangements of BW have prevented surplus land and operational properties being released. This is targeted at [xxx], of which [xxx] is automatically returned to customers through existing regulatory mechanisms.

Reduced overhead – [xxx]

- 7.8 Costs that are currently duplicated, such as Board costs, corporate, finance, regulatory and other central services can largely be saved as they do not scale between the respective size of the two companies. This is estimated to save [xxx] per annum from 2017.

Reduced group charges – [xxx]

- 7.9 An additional [xxx] per annum will be saved from Group charges, which can now be reduced and shared across the two customer bases.

Combined retail business – [xxx]

- 7.10 Both SWW and BW have relatively small retail businesses. BW has the additional challenge of relying in its current cost base for wastewater providers for the region (Wessex and Southern) paying for the provision of meter readings. For the non-household customer base this information will be available to retailers through the central market systems and it is not clear that such payment arrangements will be possible. This provides BW with a significant cost challenge to the retail business in the future.
- 7.11 By combining household retail operations, with the establishment of a separate non-household retail business, cost savings of [xxx] per annum are expected.

Wholesale operational savings – [xxx]

- 7.12 Direct operational cost savings are relatively modest compared to central and retail services. Operational and technical services will see cost reductions of [xxx] per annum from the Phase Utilisation of Remote Operating Systems (PUROS) network automation and control innovation that SWW has industry leading expertise in implementing.
- 7.13 In a similar way to retail, services to Developers will be combined across the two areas, providing developers with easier points of contact as well as keener cost of delivery. The SWW Developer Services offering provides an innovative non-statutory “trench and backfill” option to new developers which allow both parties to minimise their cost of “on-site” works. This option is available either as a direct delivered service or as part to market providers undertaking a “self-lay” option.

Business rates – [xxx]

- 7.14 Business rates of [xxx] per annum can be saved from site and property rationalisation.

Procurement and contracting – [xxx]

- 7.15 An additional [xxx] per annum of synergies will be delivered from improved contracting and procurement (for example, Kier are operational delivery partners of both SWW and BW and opportunities of scale are presented for key consumable items). This also includes some management and central planning cost savings.


Capital expenditure efficiencies

- 7.16 Efficiencies from capital expenditure delivery of [xxx] can be expected through:
- leveraging existing SWW Alliance and framework partner arrangements
 - benefits of improved asset knowledge arising from network monitoring, for instance optimising maintenance strategies.
- 7.17 These capital expenditure delivery synergy savings average [xxx] per annum up to 2020 and [xxx] per annum up to 2025.

- 7.18 The regulatory framework in which the two companies operate means that the parties will **automatically share wholesale merger synergies** which will result in reduced bills for both SWW and BW customers. Merger of retail activities are an inherent part of the future water regulatory incentive and market regime.
- 7.19 The net cost reduction resulting from the merger is anticipated **to lower customer bills across both areas by up to c. [xxx] after 2020** as the reduced costs are passed back to customers. This only represents a mechanistic application of the current regulatory framework, and Pennon anticipate that the wider service and market benefits will result in more dynamic impacts than this initial estimate.

HIGHER SERVICE QUALITY

- 7.20 As the table below highlights, current performance is good across both companies (based on 2013/14 performance). BW benefits from local focus and knowledge of the assets, with SWW able to provide more resilience and robustness over a wider area.

	 SOUTH WEST WATER	bourne-mouth water
Area of supply	10,300km ²	1,041km ²
Household customers	715,000	185,000
Non-household customers	73,000	16,000
Length of drinking water mains	15,209km	2,822km
Number of water treatment works	29	6
Number of wastewater treatment works	640	0
Leakage (m ³ /km/day)	5.5	7.4
Drinking water quality	99.98%	99.99%
SIM score	74	87
Number of employees	1,300+	200+

- 7.21 SWW and BW are both committed to delivering excellent service to customers with an ambition to be even better in the future. The merger will allow an optimised customer service package from the best of both companies practice and result in improved service for both SWW and BW customers.
- 7.22 The merger brings together two successful and customer oriented businesses that will provide even **better customer service as a combined entity**.
- 7.23 Whilst it is the current intention of Pennon to **merge BW's licence with SWW's**, there are no plans to change the BW name or remove local operational staff (particularly as SWW and BW are not contiguous and a local presence is essential for the efficient running of any water company).
- 7.24 The BW Customer View Group allows stakeholders and customer representatives scrutinise performance of their local water company. As a result, BW **customers will not see any deterioration in the local service** they currently receive: on the contrary,

the merger is likely to give rise to even higher customer service levels due to the opportunities for knowledge-sharing and greater innovation.

- 7.25 One particular source of improved service quality of the combined entity will be its ability to respond more effectively during emergencies or peak periods. Events such as severe adverse weather conditions (particularly in winter), bursts of major trunk mains and periods of drought place high demands on water companies' operational resilience. Where possible, the combined entity will be able to transfer skilled labour between the two regions to ensure the security of the water supply.
- 7.26 Even in times of normal operation, the combined entity would be better placed to cope with any unexpected incidents or system failures. This will all contribute to an improved customer experience.

TARIFFS

- 7.27 Wholesale and retail tariffs will continue to be set separately during 2015-2020 for BW customers so that compliance with the 2014 Final Determination revenue controls can continue to be demonstrated. After 2020, Pennon will also offer **ongoing protection to BW customers to reflect the current bill differential to SWW of c. 35% - 40%**.
- 7.28 The structure of wholesale charges across the two areas will also be reviewed. Extensive bottom up review of separate wholesale and retail charges within the SWW region has already occurred for 2015/16 and no changes are currently anticipated to be necessary for market opening. Further review and standardisation may be necessary in the BW area. The extensive framework developed by SWW for tariff optimisation and incidence effects testing will be used to review BW tariff structures to identify whether any improvements are necessary.
- 7.29 The SWW Board introduced a bill pledge that average household bills would increase by less than inflation throughout 2015-2020. The BW plan did not propose profiling revenues across 2015-2020 in a way that would allow this pledge to be immediately adopted for BW customers. However, the SWW Board will consider post Licence transfer, including through WaterShare, whether this approach can apply during the period so all customers benefit from this price promise.

GREATER INNOVATION

- 7.30 The merger is likely to present opportunities for greater innovation leading to increased efficiency. In particular, the merger will allow the sharing of knowledge and the adoption of best practice between two well-run businesses.
- 7.31 Areas of existing best practice which will be combined across the group include:
- **Drinking Water Safety Plans** – development and integration of Drinking Water Safety Planning approach into BW. SWW has developed a comprehensive systematised risk assessment process over recent years. The approach is strongly supported by the DWI. For the last price review (2014), investment

plans developed from the SWW process were commended as high quality by the DWI

- **catchment management** – SWW has an advanced, mature and innovative approach to catchment management and is seen by regulators and government as an industry leader in this field. SWW will apply its established catchment management approach at BW to address known catchment challenges and, in doing so, achieve long term water quality and water resource goals. The SWW model engages all stakeholders including Wildlife Trusts, River Trusts and academia. In doing so a more effective and holistic outcome is achieved and additional sources of third-party funding are unlocked, providing better overall value for money for customers
- **network management** – SWW has extensive experience of water mains rehabilitation and Distribution Operational Management Strategies which continue to address water quality challenges, transforming the customer experience. Historically, SWW was a significant outlier in network related water quality issues such as taste, odour and discolouration, but this has been transformed during recent years. Similarly the SWW approach to network planning/intelligence, mains conditioning and interruption mitigation has delivered significant performance improvements. SWW will share its approach with BW to ensure that similar benefits are delivered for BW customers
- **leakage** – SWW has led the industry for many years in the delivery of leakage performance, having both maintained and industry leading low level of leakage and consistently delivered annual leakage targets. A technology led approach to early warning of potential leaks, advanced detection resource deployment, targeted network investment to address local challenges presented by the risk of asset failure and high network pressures have ensured sustainable long term leakage control. BW faces challenges in managing network pressure more effectively and driving down leakage further than current levels to achieve similar comparative performance to SWW. Deployment of the SWW approach will deliver positive benefits for customers and ensure that the most cost effective solutions are identified and that the targeted reduction in leakage is delivered.
- **water resource strategy** – SWW has a long history of comprehensive resource planning, and is embracing the abstraction reform agenda. SWW has not had any water restrictions for 19 years and has one of the lowest consumption per head per day in the industry. BW has a similar mix of surface and ground sources to SWW which presents clear opportunity for sharing expertise to drive long term benefits for customers and the environment and support the development of the reform agenda and potential future resource trading. SWW water resource planning extends to the day to day optimisation of water resources to ensure the most cost effective deployment of all sources depending on water demand, pumping and treatment costs, availability and abstraction licence constraints. The SWW aim to deliver real time dynamic supply optimisation will be applied at BW to achieve the same benefits

- **metering** – SWW’s high meter penetration has developed comprehensive expertise in the end to end processes of delivering customer meter installation, meter maintenance and the management of the associated customer interface. With this comes effective demand management and encouragement of lower consumption and water efficiency. Associated capability includes social tariffs and meter replacement model
- **treatment capability** – SWW face very similar water quality risks and challenges to BW and are talking this by investing in leading edge treatment technology to deliver more effective whole life cost solutions. Sharing this knowledge will have significant benefits for BW customers through both risk management, quality improvements and efficiency gains
- **workforce management** – sharing SWW’s PUROS (technology based toolset for AMP5 transformational efficiency programme) with BW brings excellent opportunities for efficiency delivery through better work planning, work schedule optimisation and efficient resource deployment. Remote knowledge of asset performance will be enhanced through sharing iScada tools and Control Room capability
- **resilience** – bringing SWW and BW operational capability together will make both organisations more resilient. Particularly through shared expertise and shared resources. Specific skills, critical spares, contractor support, SEMD compliance, standardisation of equipment and mutual aid
- **stakeholder and regulator liaison** – SWW has robust relationships with both DWI and EA. Sharing of knowledge, skills and tools will enhance BW’s capabilities in this area. Public Health liaison will also be high quality. Both organisations also have good industry-wide links (e.g. IWO & UKWIR)
- **data quality and visualisation** – ability to make sound decisions is based upon good asset information. SWW has invested in processes and tools that continuously improve data quality and make information available to those who can effect better decisions
- **innovation in customer service** – with the best of both companies, from SWW’s use of social media and technology to BW’s focus on the customer experience.

7.32 The initiatives above, which are built on the best practice already undertaken within SWW, combined with new insights from BW, means that SIM performance for the combined company is expected to converge towards the level at BW. The key to this is:

- there is a key fit between the companies they have a complementary culture which allows changes to be transposed between the two organisations. This was a key reason why Pennon had the opportunity to discuss a merger with Sembcorp and why Pennon will retain use of “Bournemouth Water” as a brand
- SWW have separate ODI incentives (rewards and penalties) for operational service response, which is the main gap between SWW and other water companies on SIM, particularly on the sewerage service. This reward and

penalty performance will be extended through the WaterShare framework to cover BW customers (see WaterShare section below).

- 7.33 The separate WaterShare Panels will review and monitor the individual customer service and SIM performances, and provide enough independence to allow Ofwat to consider the use of the separate BW SIM performance at the next price review.

WATERSHARE

- 7.34 SWW developed WaterShare, a mechanism to share gains from company performance with customers in a transparent way. This includes aspects that are outside of formal regulatory mechanisms, with customer benefits arising through bill reductions or reinvestment agreed with an independent panel of customer and stakeholder representatives.
- 7.35 BW developed a similar framework, although the details were not codified in a specific way as per the SWW mechanism. Pennon is of the view that there are benefits to customers and stakeholders for BW to mirror the open and transparent principles of reporting performance in SWW's WaterShare mechanism.

OTHER BENEFITS

Reduced risk

- 7.36 There is **reduced risk from a larger entity with a strong equity financed base**. Both Pennon and SWW have a traditional debt equity finance structure in place. Both SWW and BW have gearing below the notional level for the industry of 62.5% assumed by Ofwat at the PR14.
- 7.37 The merger has been financed through an equity placement.
- 7.38 The existing securitised debt represented a key challenge in the acquisition of BW. The Artesian securitised structure which forms the vast majority of the BW business debt involves a whole company securitisation which limited mergers.
- 7.39 Pennon is in discussion with the debt providers to enable the debt funding to continue but in a way that does not fetter the business activities or market development.

POTENTIAL FOR ENABLING RETAIL MARKETS TO DEVELOP

- 7.40 The intention of Pennon is to combine BW retail non-household and household with SWW retail activities. The combined incumbent non-household retail business will subsequently be legally separated for the purposes of retail market development.
- 7.41 SWW has already committed in principle to establish a separate non-household retail business as part of the preparations for retail market opening in April 2017.
- 7.42 BW has not made a similar commitment and has been constrained by:
- securitised Artesian financing arrangements which limit establishing a separate non-household retail business, as well as placing restrictions on non-regulated activities
 - the small scale of its non-household retail activities, suggesting that internal plans therefore rely on household and non-household retail business activities remaining integrated.
- 7.43 The merger facilitates a separate non-household retail business based on incumbent arrangements across more than one wholesale area. This company will offer consolidated / joint billing across both areas. This provides significant additional choice for customers over current arrangements and resolves the issues BW would otherwise have with the scale of its retail non-household activities in the market.
- 7.44 The additional initial costs likely in establishing the market for both incumbent wholesalers and retailers will be lower than if applied separately. In any case this will be offset by synergy savings as the merger transition plan will tackle similar issues that are necessary for establishing the market.
- 7.45 The merger will also provide a single wholesale point of contact for retailers and developers across a wider area.

POTENTIAL FOR ENABLING UPSTREAM MARKETS TO DEVELOP

- 7.46 Pennon expect to move towards new arrangements that support upstream market reform – SWW and BW both have surplus water for export and the merger will facilitate this.

WHY ONLY A MERGER CAN DELIVER THESE BENEFITS

- 7.47 As demonstrated above, there is no prejudice to Ofwat's ability to make comparisons and a net benefit in all conceivable scenarios. We have made commitments on the small company premium, WaterShare and tariffs which provide assurance to customers that the benefits will accrue to them (and no detriment) before 2020. Pennon will demonstrate that the synergies by 2020 are sufficient to ensure that is a net benefit from the merger based on our modelling.

7.48 Where there is an apparent technical detriment, this is sensitive to assumptions about the future industry modelling and benchmark setting which, as in the past, Ofwat has the potential to adjust for in the modelling approach. Even where there is a modelling detriment, this is significantly outweighed by relevant cost reductions and customer benefits.

7.49 The benefits set out in the plan can only be delivered by a merger :

- the structural proposals can be delivered as a result of BW merging with SWW and allowing securitisation to be removed
- the small company premium would only be returned to customers in the short term as a result of a merger with a larger existing undertaking such as SWW
- SWW and BW can together set an improved future water wholesale efficiency frontier, which BW are unlikely to do on their own
- non-household retail separation is facilitated – joint billing arrangements are facilitated with good working relationship with other existing market participants.
- water resource sharing / expertise exists within both companies so that wider benefits can be delivered.

7.50 The timing of integrating SWW and BW and the Licence change approach is flexible to the future market developments. Nothing is constrained through this merger taking place. Following regulatory approval Pennon is committed to consider the future structure of wholesale and retail licences with Ofwat.

CONCLUSION ON MERGER BENEFITS

7.51 Without prejudice to the submission that the merger does not give rise to a net prejudice to Ofwat's ability to make comparisons, it is submitted that the benefits set out above are "relevant customer benefits" for the purpose of the WIA for the following reasons:

- the benefits accrue to current and future customers of the merging parties
- the benefits take the form of lower prices, higher quality and / or greater innovation in relation to such goods or services
- the benefits may be expected to accrue within a reasonable period as a result of the merger concerned; and are unlikely to accrue without the merger or a similar prejudice to the ability of Ofwat to make comparisons.

8. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – OVERVIEW

- 8.1 Ofwat has traditionally relied on a comparative approach to carry out its regulatory duties. For example, in comparing companies' performance, it has established the level of relative cost efficiency and scope for improvements.²³
- 8.2 In this context, a merger between two water companies reduces the number of comparators, which, in turn, may affect the reliability of a comparative assessment and therefore the strength of the cost-efficiency challenge assessed using comparisons. In other words, a merger between two water companies may adversely affect the regulatory framework. The extent, if any, to which this might be the case depends on the circumstances – for example, the relative significance and efficiency of the merging companies and the likely efficiency of the newly formed company, and the effectiveness of mitigating measures such as separate reporting.
- 8.3 A useful framework to assess the potential implications of a merger between two water companies was set out by the CC during the merger between South East Water and Mid Kent Water.²⁴ The CC developed and adopted this framework in the subsequent merger case between SST / CAM. A key aspect of this framework was an assessment of the potential impact on 'Ofwat's ability to use comparisons when setting price limits'.²⁵
- 8.4 To establish whether the SST / CAM merger could be expected to have an impact on Ofwat's use of comparisons when setting price limits, the CC undertook three separate assessments:
- **the impact of the merger on the econometric models** used to assess the relative efficiency of opex. This was assessed to have two key effects. First, the loss of precision as a result of the reduced number of observations available to Ofwat. Second, the impact on the benchmark determined by the loss of a company and the forming of the merged company
 - **the impact of the merger on Ofwat's use of the cost base analysis of capex relative efficiency.** The cost base was based on a comparison of standard capex (i.e. capex assessed for hypothetical investments that companies were asked to cost)
 - **the impact of the merger on Ofwat's use of informal comparisons** to challenge assumptions and projections in water companies' business plans.
- 8.5 In PR14, Ofwat introduced changes to the tools it uses to regulate water companies. While cross-company comparisons remain central to its approach, some of the new tools (e.g. outcomes regulation) are likely to be less reliant on comparisons. In

²³ Ofwat has used econometric tools to compare companies' OPEX and set efficiency targets for the less efficient companies to close the gap with the more efficient companies ('catch-up').

²⁴ See, for example, Competition Commission (2007), 'South East Water Limited and Mid Kent Water Limited-A report on the completed water merger of South East Water Limited and Mid Kent Water Limited', May, p. 4, point 11.

²⁵ Competition Commission (2012), 'South Staffordshire Plc/Cambridge Water PLC merger inquiry- A report on the completed acquisition by South Staffordshire Plc of Cambridge Water PLC', May, p. 4, point 9.

addition, Ofwat has introduced separate price controls for wholesale and retail business, which will also have an impact on its regulatory toolkit.

- 8.6 The framework for assessing the impact of water mergers, which has been consolidated over the last two merger inquiries, therefore needs to be adapted to the new context, and to consider the key regulatory tools currently used.
- 8.7 In the PR14 regulatory context, it is appropriate to focus on the potential impact on those areas where horizontal comparisons are still made, namely:
- **totex approach to cost assessment**, focusing the analysis on the implications for precision and benchmark effects
 - **average cost to serve** (including bad debt adjustments) approach to assess retail costs and prices
 - **service incentive mechanism (SIM)** to incentivise improvements to the quality of services provided to customers
 - **outcome delivery incentives (ODIs)** to provide companies with incentives to deliver services that customers want.
- 8.8 Oxera has analysed these aspects separately, seeking to identify the incremental impact of each. The focus of this report is on the potential impact of the merger, whether detrimental or beneficial (particularly when account is taken of efficiencies derived from the merger).
- 8.9 In assessing the impact of the merger on the comparative regime, it is necessary to compare the counterfactual scenario (i.e. no merger occurring) with the scenario in which the merger occurs. The latter will need to take into account any synergy savings that the merger will create, and their impact on the comparative regime. This is a corollary of considering the overall impact of the merger on comparative regulation, rather than simply looking at the removal of the target company in isolation. Taking into account such synergies in this case results in a benefit to the comparative regime, primarily through the creation of a more efficient comparator.²⁶
- 8.10 Moreover, there are further benefits to the merged company's customers (beyond the benefits to all customers through enhancement of the comparative regime, as discussed above). In the analysis, Oxera have not considered such direct benefits to customers, as this element is generally considered at a subsequent stage - i.e. when remedies are discussed, if such a stage is reached.
- 8.11 In past cases, water merger impacts have been assessed over a long time horizon (30 years). However, the likely degree of change in the industry for competition and

²⁶ In the Mid Kent Water/South East Water merger, both companies were average performers, and thus unlikely to affect the benchmark. As such, the synergy benefits did not affect the benchmark. In the SST/CAM case, South Staffs did not put forward synergies, and therefore no definitive numbers were discussed or accounted for. However, as part of the inquiry, it was shown that, along with creating a larger comparator (which was important in determining the benchmark under the PR09 rules), if indicative synergies of a certain size were achieved, the likelihood of creating a better benchmark would be increased. Thus, from a conceptual perspective, it was recognised in SST/CAM that such synergies should be taken into account in the comparative analysis, if applicable.

consolidation means that counterfactual analysis that assumes industry stability and BW's independence for the next 30 years is either unlikely or at least less likely than assumed in previous merger investigations.

- 8.12 In addition, at a time when the trend in regulation under the Water Act 2014 is towards more competition and less reliance on direct comparative regulation, the prospect that an independent BW – a very small WOC with quite distinct characteristics (coastal, very large individual commercial customer) – will be of material importance (in a context of 17 other WASC / WoCs) seems less likely.
- 8.13 The analysis has therefore focused on the longer timeframe as well as assessing the implications of the merger over a shorter time period (five and ten years), over which the impacts of the merger are less uncertain.
- 8.14 Over the longer time frame, the implications for the Ofwat regulatory regime arising from the merger will evolve in the context of a potentially changed industry structure as a result of the development of competition and potential regulatory and industry responses to it.
- 8.15 The changes to consider are the extent to which:
- retail competition will develop for non-household customers after April 2014²⁷ and if it will be extended to household customers
 - upstream markets (i.e. resource and treatment activities) will be opened to competition in the foreseeable future.²⁸
- 8.16 To consider the changing competitive landscape and its implications for the impacts of the merger, Oxera has developed scenarios that vary in the extent of competition and, correspondingly, reduce the scope for regulation. In other words, the scope of activities over which the existing regulatory tools are applied will reduce when competition is effective in delivering outcomes for customers.

AREAS OF IMPACT AND MARKET SCENARIOS

- 8.17 The extent to which a detriment arises depends on how the loss of the merging companies and their substitution with the merged entity affects the stringency of the incentives set by Ofwat. In addition to this is the scope of the regulatory tools employed by Ofwat going forward, which is likely to change with the development of competition in the water sector. The scope and pace of competition and, simultaneously, the withdrawal of economic regulation from competitive parts of the value chain are uncertain at this stage. Therefore, in order to capture how competition might affect the scope of regulation, Oxera has developed a number of market scenarios.

²⁷ As indicated in the Water Act 2014, retail competition for non-household customers will be introduced in England and Wales from April 2017.

²⁸ See Forward Programme 2015-16, http://www.ofwat.gov.uk/aboutofwat/plans/rpt_fwd2015-16complete.pdf - page 36

Overview of the areas of impact

8.18 The potential areas of detriment examined are as follows:

- **wholesale benchmark** – a merger may affect customers if Ofwat’s analysis of the benchmark using the wholesale cost models is adversely affected such that efficiency targets are more lenient. For example, the efficiency challenge may be weakened if an upper-quartile company is ‘lost’ and as a result the upper-quartile benchmark level becomes less stringent. Oxera has developed three approaches:
 - a static approach (looking at the impact in AMP6, which is more certain)
 - a deterministic approach, using Ofwat’s analysis developed for assessing the small company premium,²⁹ but focusing on the forecast position of companies (i.e. not considering the historical position as this is not relevant for forecasting their position in future price controls)
 - a dynamic approach, which considers changes (shocks) to the relative position of efficient and inefficient companies (efficiency ratios)
- **precision** – a merger may affect customers if Ofwat’s wholesale cost models become less precise and, as a result, Ofwat has reduced confidence in its models, which could translate into a less challenging benchmark for companies. In relation to water-only companies’ Small Company Premium (SCP), Ofwat has stated that its models will remain fit for purpose and considers that it will continue to use an upper-quartile threshold. Oxera have examined this further in the context of previous CMA approaches. Oxera have considered the theoretical approach more carefully and tried to assess this in a way that is more coherent with the PR14 approach.
- **retail benchmark** – (average cost to serve and bad debt adjustment) - a merger may adversely affect Ofwat’s approach to setting retail prices for household customers through an impact on the retail cost assessment methodology. That is, the cost to serve may be affected, resulting in a higher-than-otherwise average level for the industry. It is also of note that Ofwat may consider different approaches to setting retail tariffs for households by setting those at, for example, the upper-quartile levels. The changes to the approach taken are considered as sensitivities.
- **SIM** – a merger may affect Ofwat’s approach to setting incentives to improve quality of service. In particular, losing a company may reduce the stringency of the quality of service targets set through the SIM. However, Ofwat has signalled that it could use comparators from outside the sector in future, thus the detriment may be limited over time. In the run-up to PR14, Ofwat developed a model quantifying the impact on the SIM of the loss of BW. Oxera has developed this analysis further to consider the impact of convergence and

²⁹ Ofwat (2014) ‘Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital’ – A7A.1; and Ofwat (2104) ‘Annex to technical Appendix 6 – benefits assessment from a company specific uplift on the cost of capital’

considered the counterfactual (i.e. comparing an industry in which SWW and BW are a merged company with one where the two companies remain separate).

- **ODIs and other service metrics** – a merger may adversely affect the way in which Ofwat uses the comparison of outcomes and commitments adopted by companies and the relative penalties and rewards.

A description of the market scenarios

8.19 Oxera have developed five distinct scenarios in their analysis, which are considered in assessing the overall impact of the merger using the over-arching model. These are briefly described below, with further details provided in Annex A.

8.20 The guiding principle in assessing the implications of market and industry changes on regulation is that, to the extent that a business unit of a water company is subjected to effective competitive pressure, Ofwat may take a more light-handed approach to regulation or withdraw from regulating that business unit altogether. In this context, Ofwat would not rely on comparative tools and its regulatory action would be more focused on monitoring market outcomes (e.g. degree of switching, prices/service offers observed in the market).

8.21 Inevitably, these scenarios represent a somewhat simplified version of how markets and regulation might evolve in the future, and are unlikely to capture exactly how the market, the industry and regulation are going to develop. However, the broad range of outcomes considered should provide an indication of the likely range of impacts arising from the development of competition in the water sector.

8.22 The scenarios considered are summarised below.

1	2	3	3a	4
As is – NHH competition introduced in 2017 and limited upstream reform, as enabled through the Water Act 2014	Retail competition extended to households, building on the reforms introduced through the Water Act 2014	Retail competition and upstream competition for growth investment (e.g. the incremental contracting entity proposed in the Cave review)	Retail competition and upstream competition for the market between companies (e.g. growth investments) and competition in the market within a company's area	Retail competition and more wide-ranging upstream competition (broadly analogous to that in energy markets)

8.23 The 'as is' (the 'base case') scenario assumes that the only relevant market development is the introduction of retail competition for non-household customers in 2017 in England. As a result, the scope of Ofwat regulation would be substantially unchanged compared with PR14, and comparative tools would be used for wholesale and household retail businesses.

- 8.24 The **‘retail competition’** scenario assumes that following the introduction of retail non-household competition, Ofwat and government will decide to extend competition to household customers. An effective retail market is assumed to be in place by the beginning of PR19 and, as a result, Ofwat will cease to use comparative tools for retail activities (average cost to serve and bad debt adjustments, as well as the SIM, will no longer be relevant to the Ofwat regulatory regime).
- 8.25 The upstream competition for growth investments and activities (**the ‘Retail competition and partial upstream markets’**) scenario assumes functioning retail competition (see above) and also that a degree of competition will become established for the developing new sites (through inset appointments or competitive tendering strategies by the incumbent company). In this context, Ofwat may decide not to apply comparative tools to growth investments (in essence, supply and demand balance investments and solutions), thereby reducing the cost base for which cost models are used to assess the comparatively efficient level of totex from the beginning of PR29, when competition to carry out growth investments is assumed to be well developed.
- 8.26 The upstream competition for the market (the **‘Retail competition and more extensive competition for the market’**) scenario assumes functioning retail competition (see above) and also that a degree of competition for the market will develop. For example, companies could compete to provide bulk supplies and a system operator (deciding on which water resources to use) would be formally constituted. In summary, in this scenario, upstream outcomes would be driven by competition for the market, and through the choices of the system operator. In this context, Ofwat may decide not to apply comparative tools to upstream assets and activities (i.e. water resource and treatment), thereby reducing the cost base for which cost models are used to assess the comparatively efficient level of totex from the beginning of PR29, when competition is assumed to be well developed.
- 8.27 The upstream competition in the market (the **‘Retail competition and more extensive competition for and in the market’**) scenario assumes a functioning retail competition (see above paragraph) and also that a degree of competition in the market will develop. This scenario would require more radical changes (e.g. to enable a fully functioning water resource market). Ultimately though the outcomes would be similar to the previous scenario. In other words, Ofwat may decide not to apply comparative tools to upstream assets and activities (i.e., water resource and treatment) reducing the cost base for which cost models are used to assess the comparatively efficient level of total expenditure from the beginning of PR29 when competition is assumed to be well developed.

OVERVIEW OF THE MODELLING APPROACH

- 8.28 This section sets out how Oxera has used different strands of work to assess the overall impact of the merger under the different future regulatory and market scenarios. First, the modelling strategy is presented, followed by the results and sensitivities.

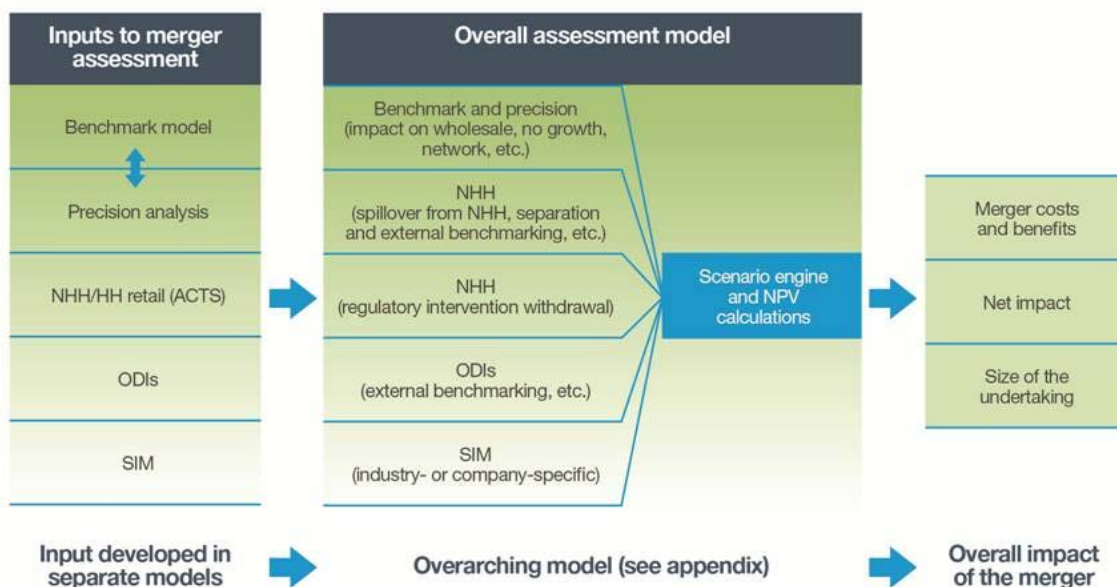
8.29 To assess the likely impact of the merger on Ofwat’s comparative regime, a number of models have been developed. The key modelling principles adopted are:

- impacts over time: the impacts of the merger are assessed over 5, 10 and 30-year time horizons (given that the shorter term impact could be considered as more certain)
- use of the counterfactual: for each area of potential impact and each market scenario, the analysis compares the situation with the merger against what would happen without the merger – in other words the costs and benefits of the merger are incremental to what would happen without the merger.

8.30 The underlying models for each area of potential impact provide net cost or benefit cash-flow streams over the entire 30 year period of analysis. These feed into the overarching model as the model inputs. The overarching model allows for:

- **assessment at price controls** – the implications of the merger are assessed separately and can be modified at each price control. For example, this allows developments in market reform over time to be considered and effects on a specific regulatory tool to be consistently accounted for (e.g. effects on average cost to serve could be changed from PR29 onwards if the retail competition scenario is considered)
- **scenario analysis** – the overall impact of different market scenarios can be modelled by selecting the relevant stream of net benefits and costs over time.

8.31 The diagram below presents a high-level overview of the mechanics of the overarching model (see Annex A for more details).



8.32 The results for the different areas of impact are brought together in this section to provide an indication of the likely magnitude of the overall impact of the merger. While some of the implications of the merger are likely to be long lasting (e.g. the cost

efficiency achieved, such as reduced overheads, are incremental, merger-specific and long term in nature and unlikely to be eroded by general efficiency improvements), other impacts (e.g. impact on SIM) may be considered more certain over a relatively short time horizon (e.g. five to ten years) and less certain in the medium to long term period. To account for this, the analysis has been carried out over three different periods (thirty, ten and five years). The results are reported separately in the following tables.

Scenario (£m)	ACTS: Bad Debt	Benchmark	SIM	ODI	Precision	Net impact
1. 'As is'						
2. Retail Competition						
3. Retail competition and partial upstream markets						
3a. Retail competition and more extensive competition for the market				residual as 4.		
4. Retail competition and more extensive competition for and in the market						

8.33 The analysis over a thirty year period shows that the overall impact of the merger is a benefit. Indeed, across different market scenarios the merger results in overall benefit between [xxx] and [xxx].

Scenario (£m)	ACTS: Bad Debt	Benchmark	SIM	ODI	Precision	Net impact
1. 'As is'						
2. Retail Competition						
3. Retail competition and partial upstream markets						
3a. Retail competition and more extensive competition for the market				residual as 4.		
4. Retail competition and more extensive competition for and in the market						

8.34 The analysis over ten years shows that the overall impact of the merger is a benefit. Indeed, across different market scenarios the merger results in overall benefit between [xxx] and [xxx]. It is of note that as upstream markets changes would affect the scope of regulation from PR29 onwards, the results do not change across scenarios 1 to 4.

Scenario (£m)	ACTS: Bad Debt	Benchmark	SIM	ODI	Precision	Net impact
1. 'As is'						
2. Retail Competition						
3. Retail competition and partial upstream markets						
3a. Retail competition and more extensive competition for the market				esi as 4.		
4. Retail competition and more extensive competition for and in the market						

8.35 The analysis over five years shows that the overall impact of the merger is relatively immaterial. It is of note that as upstream markets changes would affect the scope of regulation from PR29 onwards, the results do not change across scenarios 1 to 4.

8.36 In summary the analysis shows that:

- the impact of this merger on the water industry customers is a benefit
- this result is driven in particular by the fact that the merger will lead to the creation of a better comparator both for retail and wholesale activities
- the merger is beneficial to the comparative regime. That is, the mergers is beneficial even without considering the potential direct benefits to the merging companies' customers
- this result is consistent over the different time horizons considered.

8.37 If no synergy savings are assumed to occur, the merger impact is a smaller benefit of between [xxx] and [xxx] (see Annex A for details). However, a key focus of this merger is the achievement of synergy savings, as such this scenario is highly implausible. In fact, benefits from the merger would be even more significant if more than [xxx] of the expected synergy benefits were included in the analysis.

9. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – PRECISION

- 9.1 Detailed analysis in Annex B shows that the merger between BW and SWW has no material impact on the precision of Ofwat's cost models, such that there is no prejudicial impact on Ofwat's ability to use the upper quartile efficiency challenge.
- 9.2 Indeed, Ofwat agrees on this point. In PR14, Ofwat stated that with respect to the loss of a WoC, "the models continue to be fit for purpose to enable an upper quartile efficiency challenge; that is, there would be no need to set a less stringent efficiency challenge to compensate for any lack of precision in our models."³⁰
- 9.3 In PR14, the main modelling approach was using a panel dataset,³¹ based on which companies' performance is assessed. Compared to a cross-sectional approach, such as that used in PR09, a panel dataset can substantially improve the statistical precision of econometric modelling, as it leads to an increase in the sample size of the models.
- 9.4 Our assessment follows three approaches considered by the CC in the South East Water-Mid Kent³² (2007) and SST CAM³³ (2012) merger inquiries, and the recommendations in the Europe Economics (2015) report for Ofwat on approaches to valuing the impact of the merger on precision³⁴:
- the **theoretical approach** provides an assessment of attrition in the precision of the model estimates from the loss of a comparator. Based on this approach, Oxera show that the potential worsening in precision due to the loss of a comparator is not severe compared to those estimated under this approach for the wastewater models. Moreover, results indicate that extending the panel datasets used at PR14 will lead to a benefit in precision which will more than offset the loss of a comparator
 - the **general approach** is used to quantify the theoretical impact of losing a comparator on cost reduction targets. The application of this approach is not suited for the PR14 botex and totex models, which assume a complex cost-cost driver relationship³⁵ and are characterised by a high number of insignificant variables. Overall, the analysis of unit costs gives a marginal detriment in three models out of four. Applying bootstrapping as an alternative approach to the unit cost and econometric models, and comparing the results

³⁰ Ofwat (2014), 'Final price control determination notice: annex 3 – benefits assessment of an uplift on the cost of capital', December, p. 8, available at: https://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212riskrewardbenefits.pdf

³¹ That is, the modelling approach used data on companies over time.

³² Competition Commission (2007), 'South East Water Limited and Mid Kent Water Limited- A report on the completed water merger of South East Water Limited and Mid Kent Water Limited', May, available at: http://webarchive.nationalarchives.gov.uk/20130704020426/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2007/fulltext/525.pdf.

³³ Competition Commission (2012), 'South Staffordshire plc/ Cambridge Water plc merger inquiry (CC)- Appendices and Glossary', May, available at: http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/south-staff-cambridge-water/final_appendices_and_glossary.pdf, pp. E9-E10.

³⁴ See Europe Economics (2015), 'Valuing the Impact of Mergers and Identifying Undertakings in Lieu', May, p. 3.

³⁵ Ofwat used a translog model in its analysis where some of the cost drivers (length of mains, density and usage) were included in the models in translog form that includes second-order terms (i.e. cross-products and squared terms).

in the counterfactual (with 18 companies) and factual (with 17 companies) case, indicates that, the bias (as measured by this approach) improves marginally post-merger

- the **specific approach** is used to evaluate the specific impact of the BW / SWW merger on confidence widths and other measures of statistical and economic performance. Thus, it is the only approach that can account for the characteristics of the two merging companies and the impact on real cost and cost driver data. Empirical evidence shows that the BW SWW merger can lead to an improvement in the confidence widths of the econometric and unit cost models. Moreover, the merger improves the fit of the (log) supply demand balance (SDB) model, since BW is shown to represent a statistical outlier.

9.5 Based on the three approaches (theoretical, general and specific) examined, it is possible to conclude that the merger has no material impact on model precision and that there is no prejudicial impact on Ofwat's ability to use the upper quartile efficiency challenge:

- **statistical approach:** the level of precision with one fewer comparator in the PR14 water models does not reduce to that of the wastewater models, where there are only 10 comparators, and for which Ofwat has deemed an upper quartile challenge appropriate. Moreover, precision can be improved by extending the timeframe of analysis to mitigate any possible impact;
- **theoretical approach:** there is no clear impact of the merger on cost-reduction targets. This approach was developed in the context of PR09 models – in contrast, the PR14 botex and totex models have complex cost – cost driver relationships,³⁶ with up to 26 cost drivers; as such, the application of this approach is not suitable. For the cross-sectional unit cost models, the analysis suggests a marginal detriment on precision. Nevertheless, when the CC's statistical approach ('bootstrapping') – which it used in previous mergers to assess the bias in Ofwat's econometric cost models – is applied to all unit cost and econometric models, bias is reduced, on average;³⁷
- **specific approach:** the most direct approach to assessing the impact of this merger, this takes into account the specifics of the merging companies, BW and SWW, and the merged company. Replacing BW and SWW in the modelling³⁸ with the merged entity shows that the merger does not materially affect the fit of the models (R^2), and the relative accuracy of the cost predictions (as given by the confidence widths) marginally improves. Furthermore, the merger improves the performance of the supply demand balance (SDB) model, since BW represents an outlier and the merged entity would be a better comparator.

³⁶ Ofwat used a translog model in its analysis where some of the cost drivers (length of mains, density and usage) were included in the models in translog form that includes second-order terms (i.e. cross-products and squared terms).

³⁷ In its report for Ofwat on the impact of mergers and approaches to valuing them, Europe Economics argues that bootstrapping provides a sensible cross-check on the estimates of loss in precision derived from the general and specific approaches. See Europe Economics (2015), 'Valuing the Impact of Mergers and Identifying Undertakings in Lieu', May, p. 53.

³⁸ We have combined the data for SWW and BW without synergies in generating the data for the merged company.

Approach	Technique	Description	Overall assessment of the merger impact
Theoretical approach	Attrition in precision	Examine the extent to which a decrease in the sample size leads to an increase in the standard errors of the estimates	The level of precision with one less comparator does not reduce to that on the wastewater models, on which Ofwat has deemed a UQ challenge appropriate. Extending the panel models with additional years leads to a benefit in precision.
General approach	Theoretical loss of an observation	Assess a model where coefficients are perturbed based on the standard error and fewer degrees of freedom	Unit cost models show a marginal detriment. The approach is not appropriate for complex econometric models.
Theoretical/general approach	Bias in unit cost and econometric models	Check whether the models remain fit for purpose and whether the merger affects creates further possible bias	Bootstrapping shows that, on average, the potential bias in the standard error decreases post-merger.
Specific approach	Empirical loss of an observation	Assess the confidence widths before and after the BW/SWW merger	Confidence widths (CW) decrease marginally post merger.
Specific approach	Statistical performance	Measures of goodness of the fit of the model (R squared) and functional form tests	The merger has no substantial impact on model fit and the outcomes of functional form tests. In the log SDB model, replacing BW (an outlier) with the merged entity improves the model fit.

9.6 Overall, the evidence indicates that there is no material impact on precision from the merger and thus there is no prejudice. That is, Ofwat can continue to use an upper quartile efficiency challenge, following this merger.

10. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – BENCHMARK

- 10.1 This section summarises Oxera's modelling approaches to quantify the impact of the merger on the benchmark. See Annex C for further details.
- 10.2 A merger may affect customers if Ofwat's analysis of the benchmark using the wholesale cost models is adversely affected such that efficiency targets are more lenient. For example, the efficiency challenge may be weakened if an upper-quartile company is 'lost' and as a result the upper-quartile benchmark level becomes less stringent. Oxera has developed three approaches:
- a **static approach** (looking at the impact in AMP6, which is more certain);
 - a **deterministic approach**, using Ofwat's analysis developed for assessing the small company premium,³⁹ but focusing on comparing the factual and counter-factual scenarios and the forecast position of companies (i.e. not considering the historical position as this is not relevant for forecasting their starting position at PR19); and
 - a **dynamic approach**, which considers changes (shocks) to the relative position of efficient and inefficient companies (efficiency ratios).
- 10.3 In PR14, Ofwat undertook a total expenditure (totex) assessment of wholesale costs and set companies' cost allowance based on an upper quartile efficiency challenge. The merger of SWW and BW results in 'losing' SWW and BW, and the creation of the new merged entity. In their analysis, Oxera examine the impact that the merger may have on Ofwat's comparative regime through the wholesale cost benchmark efficiency challenge that Ofwat will be able to set in future reviews.
- 10.4 While Ofwat has not published its estimated assessment of the impact of a specific merger, it has quantified its view of the impact of 'losing' BW at PR14. It did this in its PR14 final determinations assessment of whether it should provide a company uplift on the cost of capital.¹ In this, Ofwat provides its VoC for WoCs.⁴⁰
- 10.5 While that approach can be considered a useful starting point, it is not suitable for assessing the impact of the merger between SWW and BW. In particular, the Ofwat analysis looked at the 'loss' of BW at PR14, whereas the impact of the current merger will occur at PR19. As such, while Ofwat was interested in the efficiency ranking of BW at PR14, Oxera are interested in the most likely efficiency ranking of BW at PR19.⁴¹
- 10.6 In addition, the Ofwat analysis looked at the 'loss' of BW only, and did not consider the counterfactual. As such, Oxera has built on this framework to assess the impact of the SWW / BW merger on the industry cost allowance by considering the factual (merger)

³⁹ Ofwat (2014) 'Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital' – A7A.1; and Ofwat (2104) 'Annex to technical Appendix 6 – benefits assessment from a company specific uplift on the cost of capital'

⁴⁰ Ofwat (2014), 'Final price control determination notice: benefits assessment of an uplift on the cost of capital', December.

⁴¹ As well as that of SWW and the merged company.

and the counterfactual (no merger) case. In monetary terms, this reflects the impact of the merger on the benchmark at future price reviews.

- 10.7 If the merger results in a loss of a non-upper quartile company, the upper quartile efficiency challenge faced by all companies post-merger will be more stringent, resulting in a net benefit to the comparative efficiency regime.⁴² This is the most likely situation with regard to SWW and BW at PR19, since, under Ofwat's PR14 assessment, SWW is ranked first and BW ninth based on their business plan projections. The benchmark improves post-merger as the merged company is ranked first.
- 10.8 The longer-term impact of the merger depends on what happens to the rankings in future. If, for example, both merging parties are likely to be upper quartile performers or both non-upper quartile, the likely impact of the merger is a detriment under the former and a benefit under the latter case. However, if one of the merging parties is more likely to perform significantly better than the other and influence the upper quartile benchmark, the merged entity's performance relative to the upper quartile determines the effect of the merger. As such, a key question in determining the likely impact on Ofwat's wholesale cost comparative regime in the longer term is the likely future ranking of the merged company.
- 10.9 With regard to this question, the impact of merger-specific synergy savings is critical. In terms of the merged entity being more efficient, such cost savings have the potential to create a better comparator than either of the merging parties, thereby setting a more challenging benchmark on the rest of the industry in the post-merger case. As such, it is essential to take into account the impact of such synergy savings as they could produce a benefit for Ofwat's comparative efficiency regime. This is the situation in the case of this merger.
- 10.10 The overall results on the impact of the merger on the wholesale benchmark are presented in the table below.

Approach	Impact at PR19 over 5 years	NPV impact over 30 years
Static approach	██████████	–
Deterministic approach	–	Benefit of ██████ or detriment of ██████ depending on the probability assumptions. The average of these two impacts is a benefit of ██████
Dynamic approach ¹	–	Benefit of about ██████

- 10.11 Under the **static approach**, which looks at the immediate impact of the merger on the benchmark at PR19, there is a **benefit of about [xxx]** due to the upper quartile benchmark becoming more stringent, even without considering synergy savings in the

⁴² This is because, in the counterfactual case with 18 companies, the upper quartile lies between the 5th and 6th ranked companies' scores. In the event of a loss of an upper quartile company due to a merger, the benchmark in the factual case with 17 companies improves to the 5th ranked company, thereby setting a more stringent challenge on the industry.

analysis. The upper quartile benchmark improves by about [xxx] due to losing a non-upper quartile company in BW. Similar to SWW's position in PR14, the merged company remains the frontier company at PR19, even without synergy savings.⁴³ Thus, the expected synergies will not shift the benchmark in the post-merger case.⁴⁴ As we are only interested in the impact of the synergies on the rest of the industry, given that the benchmark does not shift with the inclusion of synergies, the benefit under the static case remains at [xxx] even when the expected synergies are considered.

10.12 The **deterministic approach** quantifies the potential longer-term impact of the merger over future price reviews, and follows Ofwat's VoC approach in PR14. In its analysis, Ofwat quantified the value of losing BW on wholesale costs to be [xxx].⁴⁵ To quantify the impact of this merger, this framework needs to be extended to assess a particular factual. That is, the approach needs to be repeated for three entities: BW, SWW, and the merged entity.

10.13 The impact of the merger is the difference in the expected value of the wholesale cost allowances under scenario with the merged entity less the wholesale cost allowances under scenario with BW and SWW as two separate companies. On this basis, the merger is assessed to result in a small detriment of [xxx] (30-year NPV) under the changes approach used by Ofwat, and a benefit of about [xxx] (30-year NPV⁴⁶) under the transitions approach. Both changes and transitions methods have been used by the CC in previous merger inquiries to estimate the likelihood of movements in rankings over time.⁴⁷ As such, taking an unweighted average of the impact from these changes results in a benefit of about [xxx] (30-year NPV).

10.14 In five-year NPV terms⁴⁸, the impact is a small benefit of [xxx] under Ofwat's changes approach and a benefit of [xxx] under Oxera's transition probabilities (giving an average benefit of [xxx]). In 10-year NPV terms⁴⁹, these numbers are, respectively, a small benefit of [xxx] under Ofwat's probabilities and a benefit of [xxx] under Oxera's transition probabilities (an average benefit of [xxx]).

10.15 In this approach, with the exception of alternative probability assumptions, Oxera have used Ofwat's inputs in terms of probabilities and efficiency ratios as used in its VoC analysis both in the factual and counterfactual cases. As noted in the static case, the merged company is at the frontier at PR19 even without the expected synergies. As such, by construction, the expected synergy savings cannot shift the benchmark in the

⁴³ We have only included [xxx] of expected synergy savings in the analysis. In particular, the synergy savings, in annual non-cumulative terms and in 2012/13 prices, are assumed to be around [xxx] in PR19, and around [xxx] from PR24 onwards. The merged company's efficiency score very closely matches that of SWW's under these synergy savings.

⁴⁴ In the post-merger case with 15 companies, the benchmark is determined by the efficiency score of the 5th ranked company.

⁴⁵ Ofwat (2014), 'Final price control determination notice: policy chapter A7-Annex3: benefits assessment of an uplift on the cost of capital', December, Table A7A.3.

⁴⁶ I.e. impact at PR19 through to PR39 is converted to present values using a 3.5% discount rate.

⁴⁷ Oxera's transition probabilities are based on observed changes in totex rankings conditional upon the starting rank (Appendices 1 and 2 describes the approach in more detail). Ofwat's modelled changes method uses historical opex and capex information, and assume normally distributed rank movements and calibrate the variance of these movements to the observed movements. Under Ofwat's approach, starting ranks are taken into account in a limited sense in that, from an a priori point of view, a starting rank of 1 implies fewer small movements (i.e. with high probability under normality), while a start rank of 8, say, implies many of them.

⁴⁸ I.e. impact at PR19 is converted to present values using a 3.5% discount rate.

⁴⁹ I.e. impact at PR19 and PR24 is converted to present values using a 3.5% discount rate.

post-merger (factual) case, and thus the benefit under the deterministic approach is estimated to be about [xxx] (30-year NPV).

10.16 As an alternative to the deterministic approach, Oxera has developed a **dynamic simulation model** to simulate the comparative efficiency exercise a large number of times in order to capture different possibilities over the course of future price reviews. Under this approach, the merger results in a potential benefit of about [xxx] (30-year NPV) when the synergy savings are considered in the analysis. In addition, the likelihood of the merged company being an upper quartile company at future reviews, and thereby resulting in a benefit to the wider comparative regime, is at least equal to, or higher than, the likelihood of either merging companies.⁵⁰ In five-year NPV terms, the benefit is around [xxx], and in 10-year NPV terms, it is about [xxx].

10.17 **In conclusion, the merger results in a company that is likely to be a better comparator, benefiting Ofwat's comparative efficiency regime, in terms of setting a more stringent efficiency challenge on the rest of the industry.**

⁵⁰ This is the case when synergies are considered, with or without convergence in performance, and whether Ofwat's modelled changes probabilities or Oxera's transition probabilities are used.

11. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – RETAIL AVERAGE COST TO SERVE

- 11.1 In PR14, Ofwat set separate efficiency challenges for unmetered costs and metered costs in the household retail sector. Its methodology is based on companies' costs to serve in 2013/14. In particular, for each customer type, a company with a cost to serve (CTS) per customer above the industry average cost to serve (ACTS) is deemed inefficient, and has to reduce its CTS gradually to reach the ACTS by the end of AMP6.
- 11.2 In its PR14 determination assessment of whether or not it should provide a company uplift on the cost of capital, Ofwat published the VoC analysis for the WOCs.⁵¹ In its assessment, Ofwat concluded "that there was insufficient evidence to establish that a merger would result in a detriment to customers through an impact on the retail cost assessment methodology".⁵² This assessment did not consider a specific counterfactual. As such, Oxera has built on this framework to assess the impact of the merger between SWW and BW) on the industry cost allowance by considering the factual (merger) and the counter-factual (no merger) case.
- 11.3 For this merger, two types of ACTS are of relevance⁵³: the unweighted average of companies' unmetered CTS; and the unweighted average of companies' CTS for additional metering costs for water service. Oxera have estimated the impact of the merger on the benchmark for these separately, as well as the combined impact (unmetered plus additional metering cost).
- 11.4 The impact of the merger on the benchmark largely depends on the efficiency rankings of the two merging companies. If SWW and BW are both inefficient relative to the benchmark, the merger would overall result in the removal of one inefficient company and the benchmark would improve; this would result in a benefit to the wider comparative regime in terms of reduction in the industry allowance. Conversely, if one of the companies is efficient relative to the benchmark, the merger would effectively remove one efficient company from the industry, and the benchmark could worsen.
- 11.5 When assessing the longer-term impact, the likelihood of SWW, BW and the merged entity to be efficient relative to the benchmark needs to be considered, alongside any expected convergence in cost performance.
- 11.6 Oxera assessed the impact of the merger on the benchmark using two approaches:
- **static approach** – this considers the immediate impact of the merger at the next price review (PR19) following the PR14 methodology. It is examined by comparing the impact on household revenue in the counterfactual (18-company industry structure) and factual (17-company industry structure) case through the impact on the ACTS benchmark;

⁵¹ Ofwat (2014), 'Final price control determination notice: benefits assessment of an uplift on the cost of capital', December.

⁵² Ofwat (2014), 'Final price control determination notice: benefits assessment of an uplift on the cost of capital', December, p. 32.

⁵³ This is because BW being a water only company does not affect ACTS for sewerage only, and water and sewerage customers.

- **deterministic (probabilistic) approach** – this considers the longer-term impact of the merger by examining the likelihood of the merging companies and the merged company to influence the benchmark, and thereby the efficiency challenge set for the industry. This approach uses Ofwat’s PR14 VoC analysis for the water-only companies (WoCs) as a basis, and information on Ofwat’s expectations of how the retail efficiency challenge could evolve at future price controls, as stated in its merger consultation and statement of method paper.⁵⁴ The framework has been adapted in a merger context by focusing on the factual and counterfactual scenarios to assess the net impact on the wider comparative regime.

11.7 Under the static approach, for unmetered customers, there is a benefit of about [xxx] driven by a reduction in the doubtful debt adjustments owing to the merger,⁵⁵ which lowers the overall industry allowance. For metered CTS, there is a marginal detriment as SWW is a better than average company in the counterfactual case; however, this detriment is more than offset by the benefit on unmetered customers such that at the combined level there is an overall benefit of about [xxx] over five years.

11.8 If the doubtful debt adjustments are not re-estimated in the post-merger case, and Ofwat’s PR14 adjustments are used, the static approach results in a benefit of about [xxx] over five years. This is driven by SWW and BW relative positions at PR14. Both are assessed to be worse than the average company on unmetered costs (with rankings of 16 and 13 respectively).⁵⁶ The merger overall results in the loss of an inefficient company, which improves the industry ACTS benchmark for unmetered customers. Taking into account the detriment of [xxx] for metered customers, the net impact at the combined level is a benefit of about [xxx] over five years.

11.9 As the PR14 ACTS analysis is undertaken on a historical cost basis, Oxera have used information in the base-year period considered in the PR14 analysis, 2013/14, to examine the impact of the merger in PR19.⁵⁷ Oxera have also considered the PR14 projected costs of companies over AMP6 in the analysis in order to assess the impact. Regardless of the information used in the static analysis, the merger results in a net benefit (as shown in the table below).

Information used	Unmetered customers	Metered customers	Combined impact
Historical	18	-1	17
Forecast	7	-2	5

⁵⁴ ‘This convergence in performance is imposed in a deterministic manner as well’. See Ofwat (2015), ‘Consultation on Ofwat’s approach to future mergers and statement of method’, May, p. 70.

⁵⁵ This is because the merged entity has less extreme characteristics on drivers of doubtful debt (i.e. deprivation levels and bills) than SWW, for which Ofwat allowed a doubtful debt adjustment in PR14.

⁵⁶ The ranking are based on CTS of companies net of (i.e. excluding) company-specific adjustments for doubtful debt, input price pressure and new costs.

⁵⁷ This is in contrast to the PR14 wholesale cost assessment, which focused on assessing companies’ cost projections over AMP6 using historical information.

11.10 In its Final Determinations, Ofwat stated that its approach to setting allowed retail household revenue will evolve over time, and it is likely to consider a more stringent benchmark in future.⁵⁸ This is because it expects companies' CTS to converge over time, such that differences in CTS are minimised at future price reviews.

11.11 As such, the deterministic approach was also applied in conjunction with the upper quartile benchmark and cost convergence over time.⁵⁹ Under this approach, the benefits due to the reduction in doubtful debt adjustments as identified under the static approach are not considered.

11.12 The analysis indicates that, for unmetered costs, there is a benefit of around [xxx]. This is offset by a detriment of about [xxx] for metered customers, such that there is a net benefit of about [xxx] at the combined level.⁶⁰ The results are directionally similar to those under the static approach, and the rationale is also similar, although the overall benefit marginally reduces owing to cost convergence. In particular, the benefit in unmetered CTS is due to losing a non-upper quartile company, while the small detriment on metered CTS is due to losing a upper quartile company in SWW such that there is a net benefit at the overall level. The results under this approach in future price controls are presented in the table below:

Information used	Unmetered customers	Metered customers	Combined impact
Benchmark set at UQ (or lower quartile of companies' CTS)	38	-17	21

11.13 **In summary, Oxera's analysis indicates that the merger of SWW and BW results in a more challenging benchmark that will benefit the wider comparative efficiency regime on household retail, and thereby customers.** This result holds even without considering any merger-specific savings. To the extent that the expected merger synergies would be included, the comparative benefit could be yet more significant.

11.14 **In terms of the immediate impact of the merger at PR19, there could be a benefit of about [xxx] over five years. Under a probabilistic approach, and where Ofwat's expectations for cost convergence at future reviews are considered, there could be a benefit of about [xxx] (30-year net present value, NPV).**

⁵⁸ Ofwat (2014), 'Final price control determination notice: policy chapter A5–household retail costs and revenues', December, p. 3.

⁵⁹ In particular, following Ofwat's expectations on cost convergence, convergence was implemented in a deterministic manner by assuming that the average gap in CTS between the frontier company and the rest of the industry is closed by about [xxx] within 20 years.

⁶⁰ Unlike in the static case, the impact at the combined level is not necessarily a sum of the impacts on unmetered and metered costs. This is because, under this approach, convergence is also separately applied to combined costs. The net impact remains a benefit if the impacts on unmetered and metered customers are simply added.

12. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – SERVICE INCENTIVE MECHANISM

- 12.1 Ofwat consider that they can draw on comparators from other sectors to assess retail service quality and therefore water companies have relatively less value as comparators. Nevertheless, in the Uplift Paper Ofwat concluded that BW has benefits to customers as a SIM comparator.
- 12.2 With regards to the potential impact of the merger on the SIM, the quantitative analysis carried out by Oxera (see Annex E) suggests that, if there is a detriment, it is, at most, between [xxx] and [xxx]. Oxera consider these figures to be an upper bound of the likely range for the following reasons:
- there is strong evidence that there has been (and will continue to be) significant convergence in companies' SIM scores, this will limit the usefulness of the SIM going forward;
 - the difference between the maximum and minimum SIM scores in the industry is forecast to fall below a single point by the start of AMP7;
 - the analysis to quantify any detriment is very sensitive to the assumptions made. For example, assuming some service improvements are achieved through the merger significantly reduces the detriment, and for some scenarios show a net benefit;
 - Ofwat has already acknowledged that it could draw on comparators from other sectors to assess retail service quality and, therefore, water companies have relatively less value as comparators; and
 - furthermore, as part of the final determinations, both BW and SWW will need to maintain separate reporting of their SIM scores during AMP6. This should further decrease the impact of a loss comparator over AMP6.

BACKGROUND

- 12.3 The SIM is a comparative performance assessment introduced in AMP5 to encourage companies to improve their customers' experience.
- 12.4 The SIM was introduced to replace Ofwat's previous performance incentive, the Overall Performance Assessment (OPA), as the OPA only incentivised companies to improve performance against specific measures defined by the regulator, and companies' OPA scores had converged, reducing the scope for further significant service improvements.
- 12.5 The SIM comprises a quantitative measure (reflecting the number of different customer contacts the company receives) and a qualitative measure (reflecting customer satisfaction). When combined, these two measures give a composite score out of 100. Companies' comparative performance is then assessed, with incentives being applied in the range of [xxx] to [xxx] of regulated revenue, depending on the relative distance (standard deviations) from the industry average.

- 12.6 The first year of the 2010-2015 control period was not used for SIM incentives, so companies could refine data and have a chance to respond to the new incentive. Therefore, the SIM assessment at the 2014 price review (PR14) reflected data from 2011/12 to 2013/14. Over this period, on average, SWW was ranked 17th in the industry, and BW was ranked third.
- 12.7 As the incentive is set relative to the industry average, with regard to the possible impact of a merger, there may be a concern that the loss of a high-performing company could reduce the level of challenge applied to the rest of the industry through lowering the average score. This issue is examined below.
- 12.8 During PR14, Ofwat undertook an assessment of whether to provide a company-specific uplift to the allowed cost of capital. With regard to the SIM, Ofwat stated that it did “not consider that there would be a continuing benefit from individual WoC comparators in terms of SIM that would extend beyond the current control period.”⁶¹
- 12.9 This was largely due to observed convergence in SIM scores to date, and an expectation that such convergence would be likely to continue. It was noted (both by Ofwat and the CC⁶²) that there had been convergence in Ofwat’s previous OPA. Oxera have used Ofwat’s predicted rate of convergence in SIM in the analysis in this paper. Ofwat also noted that it could: draw on comparators from other sectors to assess retail service quality and therefore water companies have relatively less value as comparators.⁶³
- 12.10 Indeed, in its consultation on its approach to mergers, Ofwat reconfirmed that: ‘water companies are unlikely to provide as much value as retail comparators beyond 2015-2020 as Ofwat could offset the loss of a water company benchmark by greater reference to other sectors.’⁶⁴
- 12.11 Furthermore, the retail business is in a very different position to when the OPA was used. Competition is being introduced in retail non-household water in England from 2017⁶⁵, and one would expect spill-over effects (from non-household to household), and specific comparison with other utilities’ retail activities to make the SIM somewhat less relevant even sooner than it happened for the OPA.
- 12.12 It should also be noted, as part of the final determinations, both BW and SWW will need to maintain separate reporting of their SIM scores during AMP6.

⁶¹ Ofwat (2014), ‘Annex to technical appendix A6 – benefits assessment from a company-specific uplift on the cost of capital’, p. 28.

⁶² Competition Commission (2012), ‘South Staffordshire plc/Cambridge Water plc merger final report’, May, para. 4.22.

⁶³ Ofwat (2014), ‘Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital’, p. 8.

⁶⁴ Ofwat (2015), ‘Consultation on Ofwat’s approach to future mergers and statement of method’, p. 71.

⁶⁵ The Water Act 2014

ANALYSIS

12.13 Oxera have followed Ofwat's approach to examining the impact on the SIM, as set out in its decision on the uplift to the cost of capital in its final determinations.⁶⁶ However, Oxera have:

- extended Ofwat's approach and examined the impact of the merger in terms of comparing two scenarios (one with the merged company and one with SWW and BW operating separately, whereas the uplift analysis only looked at the loss of BW)
- reconsidered some of the assumptions/inputs for the analysis.

12.14 Key assumptions underlying the value of the SIM are the appropriate time period over which the impact is measured, and the likely scores for the companies involved in the merger as well as the merged company, are in Annex E.

Significant convergence in the SIM will limit the time period over which any impact of a merger occurs

12.15 Ofwat's analysis included the SIM impact over half of AMP6 (2017 to 2020) and AMP7 (2020 to 2025). This is despite clear statements from Ofwat that it does not consider that there would be a continuing benefit from individual WOC comparators in terms of the SIM that would extend beyond the current control period (AMP6). For example: It could be argued that WoCs are unlikely to provide as much value as retail comparators beyond 2015-2020 as Ofwat could offset any loss of a WoC benchmark by greater reference to other sectors, as the separation of controls leads to sharper focus on the relevant activities and services.⁶⁷

12.16 As well as using benchmarks from other sectors, the SIM's usefulness is dependent on the degree of convergence of companies' performance. Ofwat also stated: Moreover, Oxera identified a catch-up effect, where underperforming companies improved their scores by more than their better-performing peers. As a result, Oxera estimated that, if such trends were to continue with the SIM, the differences between companies could all but disappear by the start of the 2020-2025 period. This was consistent with our experience with the predecessor of the SIM, the overall performance assessment (OPA).⁶⁸

12.17 Despite this, Ofwat stated that "while our modelling continues to show a high degree of convergence after 2020, Oxera assumed that the SIM would continue to exist until 2025"⁶⁹

⁶⁶ Ofwat (2014), 'Benefits of comparators', <http://www.ofwat.gov.uk/content?id=9d01e438-8542-11e4-8fe5-b9bb2e8303f4>.

⁶⁷ Ofwat (2014), 'Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital', p. 35.

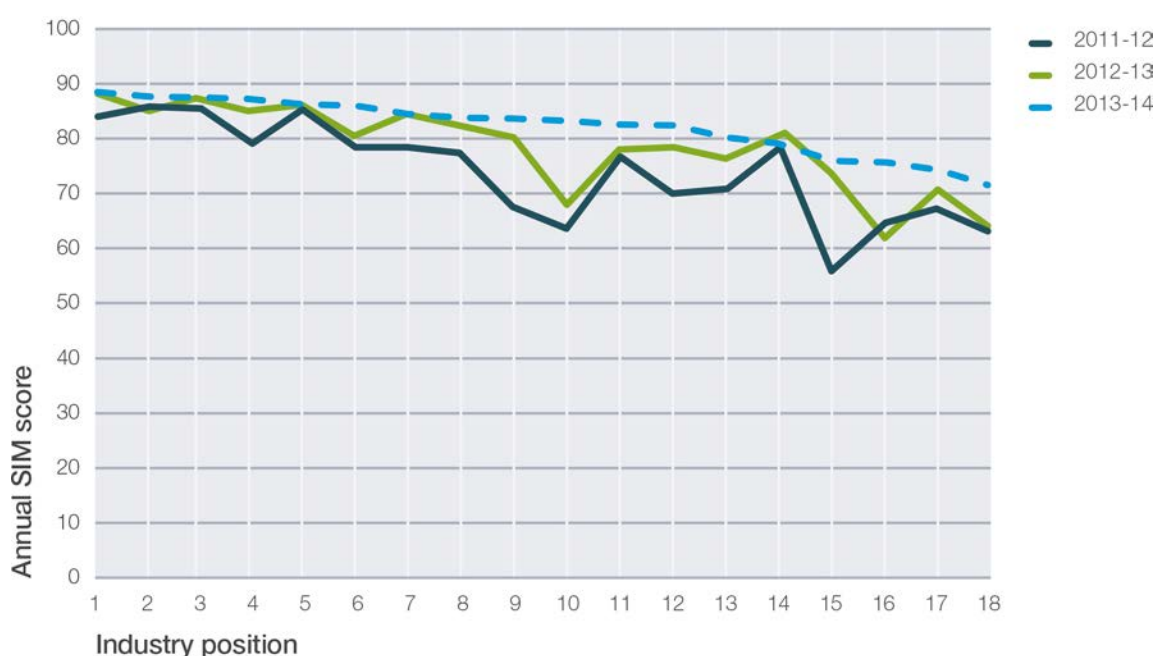
⁶⁸ Ofwat (2014), 'Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital', p. 32.

⁶⁹ Ofwat (2014), 'Final price control determination notice: policy chapter A7 – Annex 3: benefits assessment of an uplift on the cost of capital', p. 36.

12.18 In light of the caution expressed by Ofwat as to whether WoCs are of value for SIM purposes beyond 2020, the analysis presented below assesses the degree of forecast SIM convergence to determine whether assuming the SIM will continue to apply beyond 2020 is appropriate.

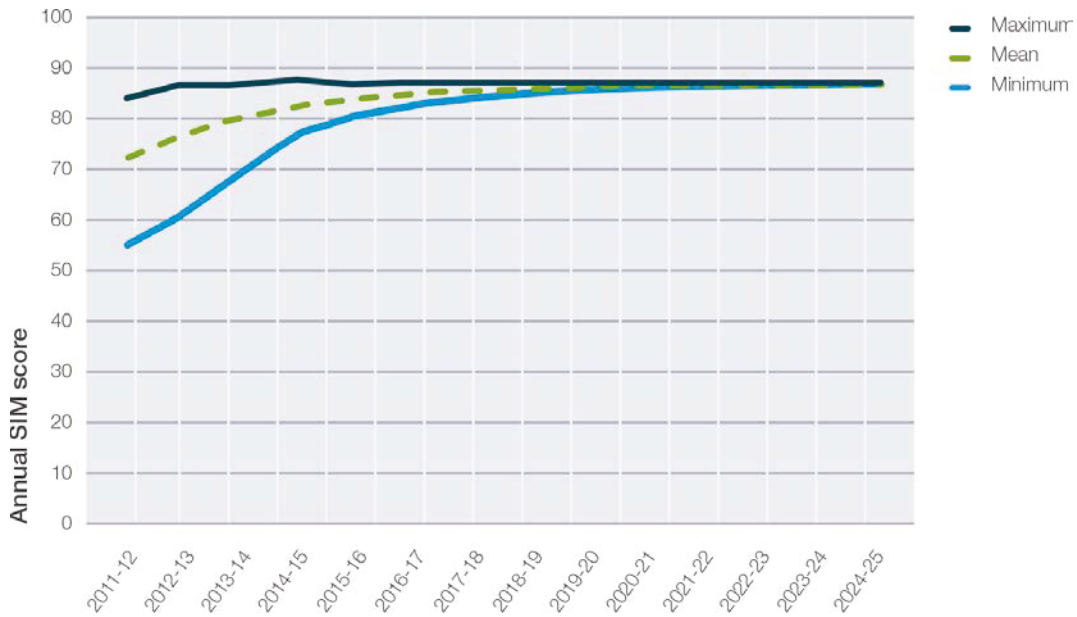
12.19 Between 2011/12 and 2013/14 the standard deviation of industry scores reduced from 8.8 SIM points to 5.0 points. There was also a significant improvement in performance of the worst-performing company in the industry. In 2011/12 the worst-performing company had a SIM score of 56; by 2013/14 the worst-performing company had a SIM score of 71. During this time, the industry frontier also shifted, but to a lesser degree. In 2011/12, the best-performing company had a SIM score of 85; by 2013/14, the best-performing company had a SIM score of 88.

12.20 The degree of SIM convergence to date is illustrated below:



12.21 As can be seen in the figure above, the industry has already heavily converged. If the SIM were to remain in place over AMP7, comparisons would need to be drawn in ten years' time – despite the majority of the variance across in the industry having already been driven out over a three-year period.

12.22 The below figure shows a combination of historical SIM convergence, and Ofwat's forecast.



12.23As can be seen from the above, not only has there been significant convergence to date, but Ofwat’s forecast is for scores to converge further. By the start of AMP7 the difference between the highest and lowest SIM score is forecast to fall to below a single point.

12.24Ofwat’s analysis forecasted the standard deviation of the industry’s SIM score over a number of years. This is shown below.

	Year	Standard deviation (SIM points)	Control period	
Outturn data	2011-12	[REDACTED]	AMP5	
	2012-13			
	2013-14			
Forecast data	2014-15			
	2015-16			AMP6
	2016-17			
	2017-18			
	2018-19			
	2019-20			
	2020-21			AMP7
	2021-22			
	2022-23			
	2023-24			
	2024-25			

12.25As can be seen from the above, using Ofwat’s’ changes probabilistic approach implies a significant degree of convergence, with the standard deviation of the industry’s SIM score falling below a single SIM point from the start of AMP7. The average standard deviation over AMP7 is forecast to be [xxx] SIM points. That means that, if SIM penalties were to still be used, Ofwat would be applying the maximum penalty to companies whose SIM scores fell only [xxx] points below the industry mean.

12.26 First, there is a question as to whether such an approach would be proportionate, given the diminishing returns to customers of improved services.

12.27 Second, there is also a question of whether the SIM as a measure is accurate enough to enable meaningful incentives to be set on such a small margin of difference, the qualitative component of the SIM (which makes up [xxx] of the overall assessment) is based on a sample of 800 customers across each company, and so may be subject to some degree of measurement inaccuracy. McCallum Layton⁷⁰ estimated that the accuracy for individual qualitative scores were +/- 3.5% for a sample size of 800.

12.28 Clearly, like the OPA before it, such convergence will limit the SIM's usefulness going forward. Given the significance of convergence on the impact of a merger on the SIM, a key question is whether Ofwat's forecast rate of convergence is reasonable. Oxera examine this below.

Ofwat's forecast of significant convergence is reasonable

Companies' price control performance commitments

12.29 In order to assess whether Ofwat's forecast (and thus its forecast convergence) is appropriate, Oxera have cross-checked Ofwat's forecast against companies' price control performance commitments.

12.30 Four companies committed to being in the upper quartile of the industry; one company committed to being in the top five companies; one company committed to being in the top three of water and sewerage companies for the qualitative component; and five companies committed to scores above the upper quartile score in 2013/14. However, no company directly committed to a SIM score above 90. *These commitments strongly suggest that there will be a significant degree of convergence in SIM scores over AMP6.*

The SIM is likely to shortly surpass the historical convergence in the OPA

12.31 Oxera have compared the forecast convergence of SIM scores with the observed convergence in OPA scores.

12.32 The OPA was discontinued at the end of AMP4. Ofwat has previously stated that the bunching of companies' OPA scores suggested that the OPA would not drive further significant service improvements.⁷¹ The last year the OPA was formally reported was 2009/10. OPA scores in that year had an overall standard deviation of 4.8.⁷² This is close to the standard deviation of SIM scores today. *Given the focus of the industry to improve further, it seems unlikely that the standard deviation of SIM scores will remain above the final position of the OPA for long.*

⁷⁰ McCallum Layton (2014), 'Ofwat SIM Survey 2013/14 Annual Report: Summary',

http://www.ofwat.gov.uk/regulating/aboutconsumers/sim/rpt_com201408simrptsummary.pdf, p. 3.

⁷¹ Ofwat (2010), 'Putting water consumers first – how can we challenge monopoly companies to improve?', p. 5.

⁷² Oxera analysis of Ofwat (2010), 'Service and delivery – performance of the water companies in England and Wales 2009–10'.

Impact

12.33 Given this evidence, Oxera consider it to be appropriate to consider the impact of the merger on the SIM over AMP6 only.

12.34 Adjusting Ofwat's analysis to reflect this gives a net impact of losing BW as a comparator for the SIM of £4.9m. However, this does not represent the impact of the merger on the SIM, as all three companies (SWW, BW, and the merged entity) need to be considered.

SIM score of the merged entity

12.35 As stated above, Ofwat's analysis calculated the industry mean score by completely removing BW as a comparator. In reality, BW's operations would not cease to exist; they would eventually merge with SWW's. Thus, the required analysis to assess the impact of the merger is somewhat different from Ofwat's, as undertaken at PR14—i.e. two scenarios need to be compared: one with SWW and BW as separate entities, and one with the merged company only.

12.36 Oxera would expect the new entity to have a different SIM score to that of SWW without the merger. The business case for the merger stated that one of the key benefits from the merger is expected to be an optimised customer service package from the best of both companies.⁷³ Oxera would therefore expect the merged entity to have a SIM score above that of SWW without the merger.

12.37 Through combining operations, it is possible for the merged entity to achieve a higher or different SIM score:⁷⁴

- in between the SIM scores of the two previous entities had the merger not occurred. If no operational benefits or issues were realised from the merger then, all things being equal, the new SIM score would be a simple weighted average of the two previous entities had the merger not occurred;
- in line with the higher of the SIM scores of the two previous entities had the merger not occurred due to the lower performer adopting the better practice techniques of the higher performer; or
- to be greater than the SIM scores of the two previous entities had the merger not occurred due to the company's management developing a 'best of both' approach to customer service.

12.38 There is no definitive way to predict which of these three scenarios would occur. On a conservative basis, to model the SIM score of the merged entity Oxera have used figures in a range between: i) being a simple weighted average of the two previous

⁷³ Pennon Group Plc (2015), 'Acquisition of Bournemouth Water – The rationale and business case', p. 5.

⁷⁴ Given the regulatory incentives and clear statements regarding improvement in the business case for the merger, we do not consider it appropriate to assume a deterioration in SIM—i.e. that the merged company would have a SIM score: i) below the SIM scores of the two previous entities had the merger not occurred; or ii) in line with the lower of the SIM scores of the two previous entities had the merger not occurred.

entities combined; and ii) the higher of the SIM scores of the two previous entities had the merger not occurred.

Impact of the merger on the SIM following an Ofwat estimation approach

12.39 Given the different assumptions that could be made in forecasting the impact of the loss of a comparator, Oxera have assessed a few options. Oxera have modelled the merged entity simply having a weighted-average score of both companies' SIM scores (i.e. no service-level synergy), and having the higher of the two companies' SIM scores (i.e. adopting better practice). Values within this range reflect the varying extent to which better practice could be adopted.

12.40 Oxera have also modelled this using the SIM scores forecast by Ofwat, and by using companies' performance commitment SIM scores. While the latter is a departure from the approach used by the CC in the past and Ofwat's final determination analysis, Oxera consider that it provides a useful sensitivity, and addresses (to an extent) the issue of Ofwat's analysis being entirely reliant on past performance and not taking into account company-specific features that may affect a firm's performance (both issues identified by Europe Economics⁷⁵). Oxera assessed the impact over AMP6 only.

NPV of industry SIM penalties (£m)	Using Ofwat's forecast SIM scores	Using SWW's and BW's performance commitment SIM scores
1) No merger		
2) Merged entity has a weighted average of SIM scores ¹		
3) Merged entity has BW's SIM score forecast		
Impact of merger range (£m)		

12.41 As would be expected, the greater the SIM score used for the merged entity, the greater the industry-wide SIM penalties—as the industry average score is increased. Indeed, assuming that the merged entity is able to achieve BW's performance commitment score results in a net benefit from allowing the merger of around [xxx].

12.42 The scenario that shows the greatest detriment of the merger is where it is assumed that Ofwat's SIM forecast scores are correct, and that there are no synergy benefits of the merger occurring in AMP6. This is as the merged entity's SIM score would be comparatively low, leading to a lower industry average score. This would give a total detriment of [xxx].

12.43 This wide range of results illustrates how sensitive the analysis is to the assumptions made, and that it may not be possible to determine definitively whether the merger would result in a negative or a positive impact.

⁷⁵ Europe Economics (2015), 'Valuing the Impact of Mergers and Identifying Undertakings in Lieu', p. 37.

12.44 However, so as to remain broadly consistent with Ofwat's approach, Oxera opted to select the range of [xxx] to [xxx] as their assessment of the likely detriment caused from the merger.

Separate reporting on SWW and SWB SIM scores during AMP6

12.45 In addition, separate reporting on SWW and BW SIM scores during AMP6 would be provided and, indeed, SIM scores for the two regions would have to be provided in order to monitor performance against the final determinations. This could further reduce the impact of the merger on industry SIM scores.

Comparisons outside the sector are possible and would more than mitigate any loss of a water comparator

12.46 It should be noted that further market and regulatory reforms may also require some restructuring of the SIM in any case. For example, if it is most efficient to have shared services for retail between households and non-households then wider business separation between wholesale and retail may occur by the next price review.

12.47 The SIM could provide some information, but is limited to being a water and sewerage sector survey on household retail including the wholesale customer services. As an alternative to the SIM, cross-sector customer surveys may be more useful, owing to both changing industry structures and SIM convergence.

12.48 The Institute of Customer Service publishes sectoral and individual company scores for customer satisfaction using a wide range of criteria. This survey requires a suitable scale of company (for example, for comparisons to the Big Six energy suppliers for customer service) and currently only nine water and sewerage companies are reported in the results, including SWW. SWW is at the lower end of the size scale for companies in the survey, and therefore some of the detailed questions are not currently reported. Mergers in the water sector therefore have the potential to allow this cross-sector source of customer service comparisons to be used as an alternative to the SIM.

12.49 This further suggests that the merger would not be detrimental to Ofwat undertaking service-level comparisons.

Conclusion

12.50 Oxera do not consider it appropriate to assume that the SIM will remain as a useful metric beyond the next five years. In reaching this conclusion Oxera have:

- assessed the degree of SIM convergence to date;
- considered companies' future performance commitments and other factors that might affect convergence;
- assessed the previous rate of convergence in the OPA;

- considered the role of other benchmarks.

12.51 Oxera have adjusted Ofwat's analysis to reflect this, and to reflect a clear counterfactual between SWW and BW operating separately, and a factual of the merged entity. Oxera's quantitative analysis suggests that if there is a detriment, it may be, at the most, between [xxx] and [xxx]. These results are sensitive to the assumptions made, and it may not be possible to determine definitively whether the merger would result in negative or positive impact on SIM.

12.52 Moreover, given that SWW and BW will maintain separate reporting of their SIM scores during AMP6, and Ofwat could draw on comparators from other sectors to assess retail service quality, Oxera consider our estimated range to be an upper bound of the likely range.

13. IMPACT OF THE MERGER ON OFWAT'S ABILITY TO MAKE COMPARISONS – OUTCOME DELIVERY INCENTIVES AND OTHER SERVICE METRICS

13.1 Based on the findings of its analysis (see Annex F), Oxera agrees with the view presented by Ofwat that there will not be quantifiable costs from the loss of one or more WoC in terms of PCs and ODIs. In particular:

- Ofwat has carried out effective comparisons with ten comparators for determining sewerage ODIs and PCs;
- few (only two) of the outcome areas require any comparative analysis for the setting of upper quartile targets;
- convergence implies that there is limited scope for further improvement in those few areas where comparisons were undertaken;
- it is questionable how much further improvement customers want to pay for - as the majority of ODIs are based on company-specific customer engagement, their customers have already indicated how they value service levels;
- local factors affect comparability as well as companies' ability to improve service levels. Moreover, BW may have unique factors that affect its relevance as a comparator such as highly seasonal population with a high peak average-demand ratio; and around 80% of the supply to customers coming from only two water treatment works;
- performance against ODIs / PCs for both SWW and BW will need to be reported in order to monitor performance against commitments at final determinations. Given that there are no plans to remove local operational staff (particularly as SWW and BW are not contiguous and a local presence is essential for the efficient running of any water company), the separate reporting of PCs over AMP6 by SWW and BW should provide sufficiently independent data points for comparison purposes.

13.2 Therefore, Pennon conclude that there is no net impact of the SWW and BW merger on Ofwat's ability to make comparisons between water companies.

BACKGROUND

13.3 For PR14, Ofwat moved from a predominantly output-based framework (for example, setting targets for the length of pipes replaced) to a more outcome-based framework (for example, setting targets for the number of supply interruptions that customers received).

13.4 Companies were given considerable freedom in developing outcomes that reflected the needs of their customers. They were also able to propose their own ODIs, PCs, and the associated rewards/penalties, following engagement with their customers.

13.5 Where Ofwat considered that companies had taken a conservative approach in their proposed performance levels and associated incentives, it intervened to ensure that

customers' interests were protected. To do this, where possible, Ofwat performed comparative analysis across the companies. However, this was limited to where companies had proposed similar measures. Due to the level of freedom given to companies in developing their proposals, there was a wide range of proposed measures and approaches.

13.6 In total, Ofwat performed 'horizontal checks' across six outcome areas:

- duration of supply interruptions
- number of contacts from customers regarding water quality
- compliance with DWI water quality standards
- number of sewerage pollution incidents
- number of properties affected by internal sewer flooding
- leakage.⁷⁶

13.7 For the first five, Ofwat set a target and a glide path for improvement, whereby companies would be required to achieve upper quartile performance by 2017/18. For leakage, Ofwat did not set a comparative target due to there being localised cost differences. For drinking water quality, Ofwat did not set a comparative target, setting PCs (for all 'non-enhanced' companies) at 100%.⁷⁷

13.8 Since two of the other outcome areas relate only to the sewerage service, of all the ODIs proposed by companies, only two are relevant to the merger (the first two listed above). For the two relevant water service outcomes, Ofwat determined the upper quartile based on a three-year average of companies' historical performance. The relative performance of SWW and BW is presented below.

Approach	Duration of supply interruptions	Number of contacts from customers regarding water quality
SWW	15	18
BW	1	4

13.9 As the industry-wide target was set relative to the upper quartile, in terms of possible impact on Ofwat's comparative regime, there may be a concern that the loss of a high-performing company could reduce the level of challenge applied to the rest of the industry at subsequent price reviews. This has been examined in Annex F.

13.10 Oxera's analysis suggests that there are significant issues in comparing exact definitions of ODIs and the UQ analysis undertaken by Ofwat at PR14 is likely to be adjusted significantly in the future. The dynamism of company performance, particularly where there are ODI rewards means any individual company, in particular

⁷⁶ Ofwat (2014), 'Final price control determination notice: policy chapter A2 – outcomes', p. 23.

⁷⁷ Not only can this score not be improved upon, but should companies achieve this target, there would be significant convergence in the industry. Should companies not achieve their PCs, Ofwat could consider setting the same target at subsequent price reviews.

a small WoC, will have very limited impact on future targets based on industry comparisons. A qualitative, rather than quantitative assessment is most likely to be appropriate where there are significant changes (such as upstream market reform is intended to deliver) that affects service performance comparisons.

13.11 ODIs are not an area of company comparisons where service levels would result in any detriment prior to the PR14 framework. Ofwat believe that dynamic efficiencies will arise from the new incentives. Analysis suggests that on interruptions to supply, SWW are incentivised sufficiently with ODI rewards during AMP6 to form the upper quartile at the next review. Combined with BW, there is no detriment to Ofwat.

Interruptions to supply

13.12 This is a measure of supply reliability to customers usually, but not always, based on minutes lost per property per year. As stated in Annex F, Ofwat have carried out effective comparisons with ten comparators for determining sewerage ODIs and PCs. Furthermore, in Annex F Oxera raise additional considerations with regard to convergence of performance and how much further customers are willing to pay for. In addition, Pennon does not consider the proposed merger will cause a detriment for this particular performance measure if required for the additional reasons outlined below.

13.13 Firstly, with ODI rewards in place, SWW are incentivised in AMP6 to meet 6 minutes per property per annum by 2019/20. BW have a target 4.4 minutes per property per annum. Both of these targets are above the UQ intervention target set by Ofwat at PR14 of 12mins/prop/year.

13.14 Secondly, using the data published in the Final Determination⁷⁸ and assuming all companies meet their targets, UQ is expected to be c. 9 minutes per property per year by 2019/20. SWW and BW are incentivised to beat this target.

13.15 Thirdly, five companies in addition to SWW have a financial incentive to improve performance beyond their base target. This means actual performance is likely to be dynamic in response to the regulatory incentive regime and therefore sector performance will be insensitive to the loss of any one company.

13.16 Finally, the data suggest there are issues regarding comparability now and in the future. Of the 18 companies in England and Wales, only 11 have common definitions for interruptions for supply reporting in AMP6. Also the rewards and penalties against this measure vary greatly between companies suggesting there are issues with consistency on how this measure is valued across customers or that the value of this measure depends on the customer preference in their area.

Discolouration contacts

13.17 This is a measure of measure of water quality acceptability and is usually measured by number of complaints per 1000 properties per year for taste, odour and discoloration. However, only 11 of 17 companies have common definitions for this in AMP6, and one

⁷⁸ http://ofwat.gov.uk/pricereview/pr14/pap_tec201412uqsuppintfd.xls

company – Thames Water – has no performance commitment in this area despite serving over nine million customers or more than 15% of the population. Whilst the issues raised in Annex F on ODIs endure, the following additional points are made.

13.18 Based on the published PR14 commitments for each company a merger of SWW and BW is not expected to have any detriment to setting future UQ Performance targets in this area if required. This is because both companies have targets in 2019/20 above the future forecast UQ. The forecast UQ is largely driven by performance from companies in the South East⁷⁹.

13.19 This metric is, however, a high customer priority and due to local factors in the South West area – softness of the water and upland nature of the environment – SWW is particularly at risk to discoloured water. SWW has a sound track record of performance in this area though as shown below. With the enhanced status of the SWW plan giving certainty on delivery, and the track record of improvements, it is therefore more likely that SWW and BW merged would form a better comparator than BW on its own.



Conclusion on ODIs

13.20 Pennon concludes that there is no net impact of the SWW and BW merger on Ofwat's ability to make comparisons between water companies with respect to ODIs and PCs.

OTHER SERVICE METRICS

13.21 Pennon has considered whether there is any potential detriment as result of the merger in respect of the loss of a comparator for other service metrics (beyond ODIs). In Annex H a table of the qualitative indicators of an impact on Ofwat's company performance, using the criteria in the Europe Economics report, is provided. In doing

⁷⁹ The South East is largely a hard water area

this a summary is provided of how the merger plans relate specifically as evidence against these criteria.

13.22 On the basis of the evidence set out in Annex H, it is clear that the merged entity is well positioned to maintain and improve other service metrics Ofwat use for comparison purposes.

14. CONCLUSION

- 14.1 Taking the potential impacts of the merger together in the round, the merger will not prejudice Ofwat's ability to make comparisons.
- 14.2 Oxera have tested a wide range of assumptions and scenarios about the future for the industry in order to establish the impact of the merger on Ofwat's ability to make comparisons.
- 14.3 Even for the extreme scenarios tested, in which there may be a small technical detriment to Ofwat's ability to make comparisons because there would be one less independently owned company following the merger, significant synergy savings resulting from the merger more than offset the small detriment.
- 14.4 Therefore, the overall impact of the transaction is beneficial to the regulatory regime.
- 14.5 Further, and separately, the merger will give rise to significant benefits for the customers of SWW and BW that could not have been achieved by either company on a standalone basis.
- 14.6 In conclusion, it is therefore submitted that the CMA should clear this merger unconditionally.

15. CREDENTIALS OF PROFESSIONAL ADVISERS

OXERA

15.1 Oxera is a leading independent economics consultancy. Oxera advise companies, policymakers, regulators and lawyers on any economic issue connected with competition, finance or regulation. Oxera have been doing this for more than three decades, gathering deep and wide-ranging knowledge as Oxera expand into new sectors. Oxera have a reputation for credibility and integrity among those Oxera advise, and among key decision-makers, such as policymakers, regulators and courts. Today Oxera have offices in Oxford, Berlin, Brussels and London, and are able to advise our international clients in a highly flexible way, including providing advice in several other languages.

ICS CONSULTING

15.2 ICS Consulting was established in 2000 and specialises in providing consultancy and support services to infrastructure businesses and regulators in the UK, Europe and Middle East. Their expertise covers:

- regulatory economics, covering policy analysis and development
- periodic review customer research
- economics analysis, including assessing monetary benefits of investment and cost-benefit analysis
- investment appraisal and optimisation, covering the design and implementation of bespoke asset management systems.

15.3 ICS is highly experienced in all aspects of the regulatory and business planning processes in the water industry and supports a number of key periodic review activities, namely:

- customer research (priorities, willingness to pay, acceptability testing)
- regulatory analyses (outcomes and incentives design, tariff formulation)
- investment optimisation and business plan development (cost benefit analyses, scenario planning, business case development)
- risk assessment (asset modelling).

FACTS INTERNATIONAL

15.4 Facts International, established in 1985, provides high quality market research to businesses and agencies around the world, and is one of the UK's leading field research providers. Facts International is part of global Marketing Services Group –

Chime Communications Plc. Chime Communications is a group of leading insight businesses that are helping to redefine the research industry.

- 15.5 They have a growing reputation in the UK water industry, having providing significant fieldwork support to a number of water companies for PR14.
- 15.6 They also have extensive field research capabilities, are available 24/7 and include face-to-face interviewing, telephone interviewing, online, mobile and mystery shopping research solutions.
- 15.7 Facts International is a member of the Market Research Society (MRS). The CEO of Facts International is a Director & Council Member of the MRS.

16. ANNEXES

16.1 The following annexes are provided separately as additional supporting information for this initial submission.

Annex A:	Oxera – Assessment of the merger of SWW and BW
Annex B:	Oxera – Precision
Annex C:	Oxera – Wholesale cost benchmark
Annex D:	Oxera – Retail average cost to serve
Annex E:	Oxera – The Service Incentive Mechanism
Annex F:	Oxera – Outcome delivery Incentives
Annex G:	ICS Consulting – Customer research into mergers
Annex H:	Other service metrics
Annex I:	Ofwat regulatory reforms and SWW response
Annex J:	Glossary