

# Completed acquisition by Pennon Group plc of Bristol Water Holdings UK Limited

## Summary of the CMA's decision on its duty to refer a merger between water enterprises under the Water Industry Act 1991

ME/6946/21

### Introduction

1. On 3 June 2021, Pennon Group plc (**Pennon**) acquired the entire share capital of Bristol Water Holdings UK Limited and its subsidiaries, including Bristol Water plc (**Bristol Water**) (the **Merger**). Pennon and Bristol Water are together referred to as the **Parties** or, for statements referring to the future, the **Merged Entity**.
2. Pennon<sup>1</sup> and Bristol Water are water utility companies, and each provide water services to household customers in England and Wales. The supply of water and sewerage services to household customers is a regulated market which in England and Wales is characterised by regional suppliers who hold regional monopolies within set sub-national regions. The market is regulated by Ofwat. Mergers between water enterprises (defined under section 35(1) of the Water Industry Act 1991 (**WIA91**) as an enterprise carried on by a water undertaker or sewerage undertaker appointed under section 6 of the WIA91) are subject to a separate review process to the normal regime under the Enterprise Act 2002. The review of water mergers is conducted by the Competition and Markets Authority (**CMA**) pursuant to the provisions of the WIA91.
3. Under the WIA91, as amended by the Water Act 2014, if the CMA believes that it is or may be the case that a completed Merger is a merger of two or

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<sup>1</sup> The Pennon business also includes Bournemouth Water, which Pennon acquired in 2015.

more water enterprises (**water merger**), it is under a duty to refer the Merger to a phase 2 investigation unless the CMA believes that:

- (a) the turnover of the water enterprise being taken over, and that of at least one of the water enterprises already belonging to the person making the takeover, is less than £10 million; or
  - (b) the Merger has not prejudiced, and is not likely to prejudice, the Water Services Regulation Authority's (**Ofwat**) ability, in carrying out its functions, to make comparisons between water enterprises; or
  - (c) the Merger has prejudiced or is likely to prejudice Ofwat's ability to make comparisons between water enterprises, but the prejudice is outweighed by relevant customer benefits (**RCBs**) relating to the Merger.
4. In reaching its decision on whether a water merger has prejudiced or is likely to prejudice Ofwat's ability to comparatively regulate the water industry, the CMA must request and consider Ofwat's opinion on whether the merger has prejudiced or is likely to prejudice its ability, in carrying out its functions, to make comparisons between water enterprises; and, if so, whether the prejudice is outweighed by RCBs.
5. The CMA believes that both Pennon and Bristol Water are water enterprises and that, as a result of the Merger, have ceased to be distinct. Accordingly, a water merger has taken place. The CMA also believes that the relevant turnover of both Pennon and Bristol Water is over £10 million.

## Assessment

6. The CMA assessed whether the Merger has prejudiced or would be likely to prejudice Ofwat's ability, in carrying out its functions, to make comparisons between water enterprises.
7. Ofwat uses comparisons to perform a number of functions, including during its periodic price reviews for setting price limits and service quality requirements, and between price reviews for monitoring and enforcement and spreading best practice. A water merger could affect Ofwat's ability to make comparisons in a number of ways across each of these functions. Therefore,

consistent with the CMA's guidance on the assessment of water mergers<sup>2</sup>, the CMA considered a number of factors for the purposes of assessing the Merger's impact, including:

- (a) the extent to which the Merger involves overlaps; and whether the Merger involves the loss of an independent comparator;
- (b) the extent to which the Merger will change benchmarks;
- (c) the number and quality of independent observations that remain;
- (d) whether the Merger leads to the loss of a company with important similarities and/or differences for comparisons; and
- (e) whether Ofwat could amend its approach to reduce the impact of the loss of a comparator.

8. In carrying out its assessment, the CMA has considered the views of Pennon, Ofwat and other third parties on: (i) the appropriate approach for determining any realistic adverse impact, based on the factors listed above; and (ii) the significance of that impact for the purposes of determining whether it amounts to prejudice. The level of customer detriment arising, in the form of increases in the allowed regulated revenues suppliers can recover through customer bills, as identified by any quantitative analysis, is only one factor in the assessment of whether any adverse impact is significant enough to amount to prejudice. Ofwat's regulation is intended to secure the achievement of a range of primary and secondary duties, including for example, that water companies can finance their activities and to further resilience and sustainability objectives.
9. Consistent with the Water Mergers Guidance,<sup>3</sup> in reaching its decision the CMA placed significant weight on Ofwat's opinion on whether the Merger is likely to prejudice its ability, in carrying out its functions, to make comparisons between water enterprises. Ofwat submitted that it believed the Merger was likely to prejudice its ability to make comparisons between water enterprises, and it provided detailed reasons to support this conclusion.

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<sup>2</sup> [Water and sewerage mergers: CMA49 \(Water Mergers Guidance\)](#)

<sup>3</sup> Water Mergers Guidance

10. Pennon provided the CMA with a report analysing the impact of the Merger. On the basis of its review of the evidence and the submissions made by Pennon and Ofwat, the CMA finds that:
  - (a) The Merger is likely to have an adverse impact on Ofwat's ability to regulate wholesale base water costs for water companies. While the CMA found that the Merger would have a limited impact on the statistical performance of Ofwat's wholesale base cost models, the CMA also found that the Merger could potentially prejudice Ofwat's ability to set the industry cost allowance. The CMA assessed whether removing a company from Ofwat's set of comparators could affect Ofwat's ability to make comparisons by removing a high or low performing company from Ofwat's benchmarks. The CMA reviewed the submissions put forward by Pennon and Ofwat who disagreed on the best approach for determining the impact of the Merger. Pennon estimated the impact of the Merger on the base cost allowance using both static and forward-looking approaches, while Ofwat submitted that the static analysis was the most informative. The CMA gave weight to both approaches put forward by Pennon and Ofwat and found that there was a realistic prospect of prejudice to Ofwat's ability to make comparisons.
  - (b) The CMA also found that the Merger could potentially prejudice Ofwat's ability to set companies' cost allowance by impacting the relationship between costs and cost drivers, resulting in the under or overfunding of individual companies. The CMA found that the Merger will lead to some material changes in the estimated allowances for some companies. Consequently, the CMA finds that this would have a detrimental impact on Ofwat's ability to set companies' cost allowances.
  - (c) The CMA also assessed whether the Merger may affect the precision with which Ofwat estimates companies' cost allowances. This, in turn, affects the confidence Ofwat has in the results of the wholesale base cost models. Pennon, Ofwat and the CMA looked at a range of methods for estimating the statistical loss in precision. The CMA concluded that while the results were mixed, overall the quantitative evidence indicated that the merger could lead to a loss of precision.
  - (d) The CMA also looked at how the Merger would impact on enhancement costs, particularly lead standards and metering enhancements. While both

Pennon and Ofwat disagreed on the appropriate methodology to assess the impact on enhancement costs, the CMA noted that both Pennon and Ofwat acknowledged that the Merger increases lead standards and metering enhancement expenditure costs. Pennon and Ofwat also disputed the appropriate method for assessing the impact of the Merger on the supply/demand balance model. The CMA again however noted that both Pennon and Ofwat acknowledged that the Merger would have a detrimental impact on the model, which may lead to the industry being overfunded or underfunded to address the critical issue of supply/demand balance.

- (e) The CMA further looked at whether the Merger would lead to the loss of a company with important similarities or differences to the remaining companies. This could affect Ofwat's ability to make comparisons across companies that are operating in similar circumstances and facing similar issues, or across companies with important differences. The CMA's analysis found that both Pennon and Bristol Water possess important similarities to other water companies within the industry that are used by Ofwat to make comparisons. The CMA therefore considers that the loss of a company with important similarities indicates that the Merger will likely have a detrimental impact on Ofwat's ability in carrying out its functions to use comparative regulation.
- (f) In addition, the CMA assessed whether the Merger would impact Ofwat's ability to set outcome targets for certain Performance Commitments (PCs) together with a package of financial and reputational Outcome Delivery Incentives (ODIs). After consideration of the evidence submitted by Pennon and Ofwat, the CMA did not consider that the Merger is likely to adversely impact Ofwat's ability to use PCs and ODIs as part of its comparative regulation of the market.
- (g) Pennon submitted to the CMA that in light of a detriment to Ofwat's ability to make comparisons, as a result of the Merger, Ofwat should be able to amend its approach to reduce the impact of the loss of a comparator. Pennon submitted that it is possible for Ofwat to regulate effectively with a far smaller number of comparators than are currently available for water services. Given the level of prejudice to Ofwat's ability to make comparisons (identified in (a) to (e) above) that may be brought about by the Merger, the CMA did not consider it credible that Ofwat could

plausibly switch to an alternative approach absent a substantial re-evaluation of its methodology.

- (h) Both Pennon and Ofwat agreed that the Merger is unlikely to have a meaningful detriment on Ofwat's ability to regulate the cost of retail activities. The CMA accepted this position and did not conduct its own analysis into whether the Merger would have an impact on the number of independent comparators in the residential retail service area.
  - (i) Pennon also submitted consumer research conducted in June 2021 with customers of South West Water, Bournemouth Water and Bristol Water. Pennon submitted that 'the research shows that customers support a merger between Bristol Water and South West Water'. The CMA found that the survey conducted possessed significant flaws in its methodology. The CMA therefore did not place weight on this evidence.
  - (j) Lastly, the CMA assessed a range of benefits put forward by Pennon that it suggested would outweigh any detrimental impact of the Merger on Ofwat's ability to comparatively regulate the market. The CMA ultimately found that there was insufficient evidence to conclude at Phase 1 that the potential RCBs would outweigh the adverse impacts of the Merger.
11. For the reasons set out above the CMA believes that it is or may be the case that a merger of two or more water enterprises has taken place (otherwise than as a result of the carrying into effect of arrangements that have been the subject of a reference by virtue of section 32(a) of the WIA91) and it does not appear to the CMA that the exclusion of small mergers under section 33 of the WIA91 applies in this case.
12. In addition, the CMA does not believe that the Merger has not prejudiced, and is not likely to prejudice, the ability of Ofwat in carrying out its functions by virtue of the WIA91, to make comparisons between water enterprises. Nor does it believe that the prejudice in question is outweighed by RCBs relating to the Merger.

## **Conclusion**

13. The CMA is therefore considering whether to accept undertakings under section 33D of the WIA91. Pennon has until 31 December 2021 to offer an

undertaking to the CMA that might be accepted by the CMA. If no such undertaking is offered, then the CMA will refer the Merger pursuant to section 32 of the WIA91, as amended by Water Act 2014.

14. The CMA's assessment in this decision under the WIA91 is unrelated to its separate assessment of the merger's effects on competition in the non-household retail water services market. The CMA approved the transaction on competition grounds under the Enterprise Act 2002 in a separate phase 1 decision on 5 November 2021.