

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

Decision that undertakings might be accepted

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. On 22 December 2021, the Competition and Markets Authority (**CMA**) decided under section 32 of the Water Industry Act (**WIA91**) that it is or may be the case that a merger of two or more water enterprises has taken place. Following its review of the Merger, the CMA found that the Merger has prejudiced, or is likely to prejudice, the ability of Ofwat in carrying out its functions by virtue of the WIA91, to make comparisons between water enterprises (the **Reference Decision**).
3. On the date of the Reference Decision, the CMA gave notice pursuant to section 34ZA(1)(b) of the Enterprise Act 2002¹ (the **Act**) to Pennon of the Reference Decision. However, the CMA did not refer the Merger for a phase 2 investigation pursuant to section 32 of the WIA91 on the date of the Reference Decision in order to allow Pennon the opportunity to offer undertakings to the CMA in lieu of such reference pursuant to section 33D of the WIA91.
4. Pursuant to section 73A(1) of the Act, if a party wishes to offer undertakings for the purposes of section 33D of the WIA91, it must do so within the five working day period specified in section 73A(1)(a) of the Act. Accordingly, on

¹ Having effect as modified by the Water Mergers (Modification of Enactments) Regulations SI 2004/3202, as amended.

31 December 2021, Pennon offered undertakings to the CMA for the purposes of section 33D of the WIA91.²

5. The CMA has consulted with Ofwat on the nature of the undertakings submitted by Pennon, including requesting, receiving, and considering an opinion on the effect of the undertakings pursuant to section 33D(6) of the WIA91.
6. The CMA now gives notice, pursuant to section 73A(2)(b) of the Act, to Pennon that it considers that there are reasonable grounds for believing that the undertakings offered, or a modified version of them, might be accepted by the CMA under section 33D of the WIA91 and that it is considering the offer.

The undertakings offered

7. Under section 33D of the WIA91, the CMA may, instead of making a reference, and for the purpose of remedying, mitigating or preventing the prejudicial effect on Ofwat's ability, in carrying out its functions by virtue of the WIA91, to make comparisons between water enterprises that the Merger has had, may have had or may be likely to have, accept from the merger parties concerned as it considers appropriate undertakings to take such action as it considers appropriate.
8. Pennon (through its subsidiary South West Water Limited) 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, which carries out this role using a system of comparative regulation between the water enterprises³ and their sub-national regions.
9. The Reference Decision found that there is a realistic prospect that the Merger has prejudiced or will prejudice Ofwat's ability to make comparisons between water enterprises.
10. To address the prejudice, Pennon has agreed to provide separate reporting information for South West Water and Bristol Water – comprising primarily of

² Pennon offered revised undertakings on 9 January 2022 and again on 10 January 2022. These revised undertakings were made in response to comments made by the CMA and Ofwat, and to correct some minor elements of the text of the proposed undertakings.

³ Defined under section 35(1) of the WIA91 as an enterprise carried on by a water undertaker or sewerage undertaker appointed under section 6 of the WIA91

separate historical and forecast cost and cost driver information - which will enable Ofwat to maintain separate wholesale water price controls, with separate revenue controls and revenue limits, for South West Water wholesale water activities and Bristol Water wholesale water activities from 1 April 2025; Pennon also acknowledges and agrees that Ofwat will maintain separate price controls for the South West Water wholesale water activities and Bristol Water wholesale water activities (the **Proposed Undertakings**),⁴ⁱ and considers that the Proposed Undertakings 'will allow Pennon to realise the benefits of the Merger but continue to provide Ofwat with the information that it needs for the maintenance of separate price controls ... which in turn enables the continuation of the existing comparisons between water enterprises in these areas'.⁵ⁱⁱ

The CMA's provisional views

11. The CMA considers that undertakings in lieu of a reference are appropriate when they are clear-cut and capable of ready implementation. For UILs in water mergers, the CMA's starting point is to seek an outcome that will restore Ofwat's ability to make comparisons between water enterprises to a level similar to that which existed pre-merger.
12. The CMA believes that the Proposed Undertakings, or a modified version of them, might be acceptable as a suitable remedy to the prejudice identified by the CMA for the following reasons.
13. The CMA currently believes that the Proposed Undertakings are capable of amounting to a sufficiently clear-cut and effective resolution of the CMA's concerns. The CMA also believes at this stage that the Proposed Undertakings may be capable of ready implementation, in particular because the Proposed Undertakings will essentially require the Merged Entity to continue to report and provide information, which is already currently provided independently for each of South West Water and Bristol Water. In addition, the agreement by Pennon for separate wholesale price controls will reflect a continuation of the situation pre-Merger. The CMA considers that separate

⁴ Pennon notes that there may be exceptions to separate price controls as regards outcome delivery incentive rates (ODIs), cost sharing rates, and performance commitments (PCs), which may be consistent across Pennon's water businesses, save to the extent there are material reasons for differences between the South West Water region and the Bristol Water region. Pennon notes that it aims to achieve consistent PC levels over time but that at the outset, PC levels will be specific to the South West Water region and Bristol Water region unless there are compelling reasons to the contrary.

⁵ Pennon Remedies Form of 31 December 2021, paragraph 12. In addition, Pennon has committed to realising and sharing with consumers certain anticipated benefits of the merger ahead of Ofwat's next price determination period beginning in April 2025. These commitments include removing the small company premium in the Bristol region, and sharing any efficiency benefits realized from the merger, including through Pennon's WaterShare+ scheme ahead of this.

wholesale price controls would not compromise Pennon's ability to merge the two businesses operationally and to extract the synergies it aims to achieve through the merger.

14. In its Phase 1 decision the CMA found that there is a prospect of the Merger having a detriment to Ofwat's ability to assess wholesale water costs. The CMA considers that retaining separate information on the wholesale water activities of South West Water and Bristol Water, along with the other commitments offered by Pennon including maintenance of separate price controls,⁶ⁱⁱⁱ will address the detriment identified in the Reference Decision.
15. As such, the CMA considers that the Proposed Undertakings will likely mitigate any loss in Ofwat's ability to make comparisons between water enterprises that may arise following the Merger.
16. For these reasons, the CMA currently thinks that there are reasonable grounds for believing that the Proposed Undertakings, or a modified version of them, might be accepted by the CMA under section 33D of the WIA91.
17. The CMA's decision on whether ultimately to accept the Proposed Undertakings or refer the Merger for a phase 2 investigation will be informed by, among other things, third party views on whether the Proposed Undertakings are suitable to address the concerns identified by the CMA.

Consultation process

18. Full details of the undertakings offered will be published in due course when the CMA consults on the undertakings offered as required by Schedule 10 of the Act.⁷

Decision

19. The CMA therefore considers that there are reasonable grounds for believing that the Proposed Undertakings offered by Pennon, or a modified version of them, might be accepted by the CMA under section 33D of the WIA91. The CMA now has until 7 March 2022 pursuant to section 73A(3) of the Act to

⁶ In particular, Ofwat considers that 'separate reporting on its own would not be sufficient' to address the prejudice identified by the CMA, and that separate controls 'would create a meaningfully stronger incentive on company management to have robust cost allocation and cost apportionment in place from the outset' of the Merger. Ofwat further considers that separate reporting without separate price controls would 'require [Ofwat] to design a new process to gather information, including because the current reporting approach would not allow us to request information on forecast costs. This would be resource intensive and entail risks to the consistency of [Ofwat's] approach to information gathering across the water sector'.

⁷ *Merger remedies (CMA87)*, paragraph 4.27.

decide whether to accept the undertakings, with the possibility to extend this timeframe pursuant to section 73A(4) of the Act to 5 May 2022 if it considers that there are special reasons for doing so. If no undertakings are accepted, the CMA will refer the Merger for a phase 2 investigation pursuant to section 32 of the WIA91.

Dr Mike Walker
Chief Economic Adviser
Competition and Markets Authority
10 January 2022

ⁱ The CMA amends the text at Footnote 4 with the deletion of the word “may” and the addition of the word “will” as set out in the text below:

“Pennon notes that there may be exceptions to separate price controls as regards outcome delivery incentive rates (ODIs), cost sharing rates, and performance commitments (PCs), which ~~may will~~ be consistent across Pennon’s water businesses, save to the extent there are material reasons for differences between the South West Water region and the Bristol Water region.”

ⁱⁱ The CMA amends the text at Footnote 5 with the deletion of the word “any” as set out in the text below:

“Pennon Remedies Form of 31 December 2021, paragraph 12. In addition, Pennon has committed to realising and sharing with consumers certain anticipated benefits of the merger ahead of Ofwat’s next price determination period beginning in April 2025. These commitments include removing the small company premium in the Bristol region, and sharing ~~any~~ efficiency benefits realized from the merger, including through Pennon’s WaterShare+ scheme ahead of this.”

ⁱⁱⁱ The CMA amends the text at Footnote 6 by adding a reference to Ofwat’s Draft Opinion on Pennon’s UIL offer as set out in the text below:

“In Ofwat’s Draft Opinion on Pennon’s UIL offer, submitted to the CMA on 7 January 2022, Ofwat noted that it considers that ‘separate reporting on its own would not be sufficient’ to address the prejudice identified by the CMA, and that separate controls ‘would create a meaningfully stronger incentive on company management to have robust cost allocation and cost apportionment in place from the outset’ of the Merger. Ofwat further considers that separate reporting without separate price controls would ‘require [Ofwat] to design a new process to gather information, including because the current reporting approach would not allow us to request information on forecast costs. This would be resource intensive and entail risks to the consistency of [Ofwat’s] approach to information gathering across the water sector’.”

The CMA notes that none of the above changes affect its decision.