

Completed Acquisition by Pennon Group Plc of Sumisho Osaka Gas Water UK Limited (now Sutton and East Surrey Group Holdings Limited)

Decision on duty to refer

ME/7083/23

The Competition and Markets Authority’s decision on whether a water merger has been created, and whether that merger is likely to prejudice Ofwat’s ability to make comparisons between water enterprises, under sections 32(b) and 33A(1)(b) of the Water Industry Act 1991, given on 3 May 2024. Full text of the decision published on 21 May 2024.

The Competition and Markets Authority (**CMA**) has excluded from this published version of the decision information which the CMA considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [X] Some numbers have been replaced by a range, which are shown in square brackets.

Contents

| | |
|--|----------|
| SUMMARY | 3 |
| ASSESSMENT | 6 |
| 1. PARTIES AND MERGER | 6 |
| 2. PROCEDURE | 7 |
| 3. JURISDICTION | 7 |
| 4. COUNTERFACTUAL | 8 |
| 5. BACKGROUND | 8 |
| 6. FRAMEWORK FOR ASSESSMENT | 9 |
| 6.1 Statutory framework | 9 |
| 6.2 CMA approach | 9 |

| | | |
|-----------|--|-----------|
| 7. | ASSESSMENT OF IMPACT ON OFWAT'S ABILITY TO MAKE COMPARISONS BETWEEN WATER ENTERPRISES | 11 |
| 7.1 | Wholesale water base costs..... | 11 |
| 7.2 | Wholesale Enhancement costs | 19 |
| 7.3 | Residential retail costs | 20 |
| 7.4 | Performance commitments and outcome delivery incentives..... | 21 |
| 7.5 | Relevant customer benefits..... | 23 |
| 7.6 | Consumer views..... | 26 |
| 7.7 | Third-party views..... | 27 |
| 8. | DECISION | 27 |

SUMMARY

1. The Competition and Markets Authority (**CMA**) has found that there is a realistic prospect that the acquisition by Pennon Group Plc (**Pennon**) of Sumisho Osaka Gas Water UK Limited (**SOGWUK**) has prejudiced or will prejudice Ofwat's ability to make comparisons between water enterprises.
2. On 10 January 2024, Pennon acquired SOGWUK. Following the Merger, SOGWUK's name was changed to Sutton and East Surrey Group Holdings Limited (**SESGHL**). SESGHL's subsidiaries include Sutton and East Surrey Water plc (**SES**). The CMA refers to this acquisition as the **Merger**. Pennon and SESGHL are together referred to as the **Parties** and, for statements relating to the future, the **Merged Entity**.
3. The Parties have until 13 May 2024 to offer undertakings in lieu of a reference (**UILs**) to the CMA that will remedy the prejudice identified. If no such undertaking is offered, then the CMA will refer the Merger pursuant to section 32 of the Water Industry Act 1991 (**WIA91**), as amended by The Water Act 2014.

Who are the businesses and what products/services do they provide?

4. Pennon and SES are water utility companies, and each provide water services to household and non-household customers in England.
5. Pennon operates as a water and sewerage undertaker in the Southwest of England through South West Water. It also operates as a water undertaker in the Bournemouth and Bristol regions, through Bournemouth Water and Bristol Water respectively.
6. SES operates as a water undertaker in parts of Surrey, Kent, West Sussex and South London, providing wholesale and retail household water services.

Why did the CMA review this merger?

7. The supply of water and sewerage services to household customers is a regulated market in England and Wales characterised by suppliers that hold regional monopolies within set sub-national regions. The market is regulated by Ofwat.
8. Mergers between water enterprises 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 CMA pursuant to the provisions of the WIA91.
9. 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 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 greater than £10 million; or
- (b) the Merger has not prejudiced, and is not likely to prejudice, the Water Services Regulation Authority's (Ofwat's) 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.

10. The CMA considers that both Pennon and SES 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 SES is greater than £10 million.

What evidence has the CMA looked at?

11. The CMA has taken into account submissions made by Pennon, including modelling undertaken by its economic advisors Oxera (**Oxera**), Ofwat's opinion on the Merger, and third-party views of the Merger.

What did the evidence tell the CMA about the impact of the Merger on Ofwat's ability to regulate the water market?

12. Ofwat uses comparisons to perform a number of functions, including during its periodic price reviews for setting revenue allowances and service quality requirements, and between price reviews for monitoring and enforcement and setting best practice.

13. Based on evidence received by the CMA, the CMA has found that the Merger has prejudiced or would be likely to prejudice Ofwat's ability, in carrying out its functions, to make comparisons between water enterprises. In particular;

- (a) the Merger is likely to lead to a loss of precision for Ofwat's wholesale cost models at both a company level and at an industry level;
- (b) the Merger may have a detrimental impact on Ofwat's ability to set the industry cost allowance by removing a high or low performing company from Ofwat's benchmarks;

- (c) the Merger could lead to the loss of a company with important characteristics in residential retail, for example in relation to average bill size and deprivation score and this could prejudice Ofwat's ability to regulate the cost of residential retail activities;
- (d) the loss of SES as an independent comparator could adversely impact Ofwat's ability to use performance commitments and outcome delivery incentives as part of its comparative regulation of the market; and
- (e) there is insufficient evidence to conclude at Phase 1 that RCBs would outweigh the adverse impacts of the Merger.

What happens next?

14. The CMA is considering whether to accept undertakings under section 33D of the WIA91. The Parties have until 13 May 2024 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 The Water Act 2014.

ASSESSMENT

PARTIES AND MERGER

15. Pennon is a water utility company listed on the London Stock Exchange.¹ Pennon operates as a water and sewerage undertaker in the Southwest of England through South West Water Limited (**South West Water**).¹ It also operates as a water undertaker in the Bournemouth and Bristol regions, through Bournemouth Water and Bristol Water respectively.² South West Water is responsible for providing wholesale and retail household services in these regions, serving a population of approximately 3.5 million, across nine counties.³
16. SESGHL is active in the supply of regulated water services through SES. SES operates as a water undertaker in parts of Surrey, Kent, West Sussex and South London, providing wholesale and retail household water services. SES serves a population of approximately 750,000 customers in these areas.⁴ SESGHL also supplies water and sewerage retail services to non-household customers through SES Business Water.
17. Pennon acquired the entire issued share capital of SOGWUK, pursuant to a share purchase agreement dated 10 January 2024.⁵ Following the Merger, SOGWUK's name was changed to SESGHL.⁶ The Parties submitted that the transaction provides a unique opportunity for Pennon to acquire an attractive water-only company that is well-positioned to benefit from population growth in its region, and that Pennon has the opportunity to optimise SES' operations and customer interactions, which Pennon is well positioned to deliver given its experience with integrating the acquisitions of Bournemouth Water and Bristol Water and driving improvements in those businesses.⁷ The Parties also submitted that the transaction gives rise to the following additional benefits: (1) an equity injection into the SESGHL business to reduce SES' gearing levels; (2) the removal of a request for a small company premium at PR24; and (3) returning efficiency

¹ Final Merger Notice submitted to the CMA on 6 March 2024 (FMN), paragraph 3.1.

² On 3 June 2021, Pennon acquired the entire share capital of Bristol Water Holdings UK Limited and its subsidiaries, including Bristol Water plc.

³ Pennon also supplies water and sewerage retail services to non-household customers through two joint ventures in England and Wales (Water 2 Business and Pennon Water Services (trading as Source for Business)). SESGHL is also active in the supply of water and sewerage retail services to non-household customers through SES Business Water. Accordingly, there is an overlap between the Parties in non-household retail water services. However, the Parties' combined shares are low and the CMA does not believe that any plausible competition concerns could arise under the Enterprise Act 2022 as a result of this overlap. Non-household retail services are therefore not discussed any further in this decision.

⁴ FMN, paragraph 3.2.

⁵ FMN, paragraph 2.1.

⁶ Email from Pennon's legal advisers to the CMA on 27 February 2024, paragraph 2.1.

⁷ FMN, paragraph 2.2.

savings to customers that are over and above those which will be determined by Ofwat at PR24.⁸

PROCEDURE

18. The CMA commenced its phase 1 investigation on 7 March 2024.
19. On 9 April 2024, the Parties informed the CMA that they accepted that the test for a reference of this Merger is met on the basis that there is sufficient evidence to indicate that there is a realistic prospect that the Merger has prejudiced or will prejudice Ofwat's ability to make comparisons between water enterprises under the WIA91. The Parties requested that the case be fast tracked to the consideration of UILs. As part of the request, the Parties agreed to waive some of their normal procedural rights, including their right to an issues meeting and to challenge the CMA's finding of prejudice during the phase 1 investigation.⁹
20. As set out in the CMA's guidance,¹⁰ the parties to a merger are able to waive their rights in relation to certain procedural steps within a merger investigation in order to enable a binding outcome to be arrived at more quickly. In agreeing to fast-track the case to the consideration of UILs, the CMA has, in keeping with the process set out in its guidance, had regard to its administrative resources and the efficient conduct of the case and decided that it was appropriate to proceed to consideration of UILs.

JURISDICTION

21. Each of the Parties are water undertakers appointed under Section 6 of the WIA91.ⁱⁱ The CMA therefore considers each of the Parties to be water enterprises as defined under section 35(1) of the WIA91. Each Party generated a relevant turnover in excess of £10 million in their most recent financial years, therefore the turnover test as set out at section 33(1) of the WIA91 is met.¹¹ As a result of the Merger both Pennon and SES have ceased to be distinct.
22. The CMA therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in a merger between two or more water enterprises (ie a water merger).
23. The Merger completed on 10 January 2024. The initial period for consideration of the Merger as defined in section 34ZA(3) of the Enterprise Act 2002 started on 8

⁸ Merger Impact Assessment submitted to the CMA on 6 March 2024 (**Merger Impact Assessment**), paragraph 6.2-6.3.

⁹ [Mergers: Guidance on the CMA's jurisdiction and procedure \(CMA2\)](#), December 2020 (as amended on 4 January 2022), paragraphs 7.1, 7.10 and 7.14.

¹⁰ [CMA2](#), paragraphs 7.8–7.13.

¹¹ FMN, paragraph 5.1.

March 2024 and the statutory 40 working day deadline for a decision is therefore 7 May 2024.

COUNTERFACTUAL

24. The CMA assessed the impact of the Merger on Ofwat's ability to carry out comparisons against the situation that would prevail in the absence of the Merger. Consistent with its approach to general Phase 1 merger investigations, the CMA believes the most cautious realistic counterfactual is a situation where the Merger is assumed not to have occurred and the two firms continue to operate under independent ownership.

BACKGROUND

25. The water industry was de-nationalised in 1989 when the public owned suppliers of water and sewerage services were privatised and became water and sewerage companies.
26. Today, there are 11 water and sewerage companies, and five water only companies operating within England and Wales. Within its area of operation, each water company is a virtual monopoly for domestic customers, and domestic customers have no choice of supplier.
27. The regulator for the market, Ofwat, has a set of primary and secondary duties and functions.¹² One of the functions is to set price limits every five years, determining the maximum companies can charge customers for water and wastewater services. Ofwat also monitors the performance of the water companies to ensure that they deliver the required services and improvements in quality. The regional monopolisation of the market drives the need for Ofwat's comparative approach to regulating the sector. Ofwat uses comparisons to perform a number of functions, including during its periodic price reviews, and between price reviews for monitoring and enforcement and spreading best practice.

¹² Ofwat's duties for most of its work as the economic regulator of the water sector are laid down in sections 2 and 3 of the WIA91 as amended. These duties include, among others, to: further the consumer objective to protect the interests of consumers; secure that water companies properly carry out their statutory functions; secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions; further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems; and to secure they take steps to enable them in the long term to meet the need for water supplies and wastewater services; promote economy and efficiency by water companies in their work; and contribute to the achievement of sustainable development (see [Our duties - Ofwat](#))

FRAMEWORK FOR ASSESSMENT

Statutory framework

28. In carrying out its assessment of the Merger, the CMA has followed the approach set out in the CMA's guidance on the assessment of water mergers. This guidance sets out relevant factors that the CMA will consider when assessing the impact of a water merger on Ofwat's ability to make comparisons.¹³
29. In line with the approach taken in previous investigations,¹⁴ for the purposes of its Phase 1 assessment of a water merger the CMA has interpreted the statutory test as requiring it to:
- (a) first, assess whether there is a realistic prospect that the impact of the Merger on Ofwat's ability to make comparisons between water enterprises is adverse; and
 - (b) second, consider whether any adverse impact, either individually or in combination with any other adverse impact(s), is significant enough to amount to prejudice.

CMA approach

30. Currently, SES and SWB are separate regulatory comparators, where SWB refers to the combined entity of South West Water and Bournemouth Water.¹⁵ The Merger (absent UILs) would result in these becoming a single comparator.
31. In order to assess the impact of the Merger on Ofwat's ability to make comparisons between water enterprises, taking into account the factors set out in the statutory framework, the CMA has considered each of the ways in which Ofwat uses comparisons. These broadly fall into two categories: setting cost allowances and setting service quality levels.
32. In terms of cost allowances, Ofwat is responsible for setting future cost allowances for water companies every five years. Ofwat sets a funding allowance (totex) to cover forecasted necessary costs for each water company and uses comparative analysis to set these at an efficient level. During its last price review, PR19, Ofwat established the totex allowance for water companies based on three main building blocks:

¹³ See [CMA49](#), paragraphs 4.15 to 4.22. These factors are also set out in Pennon/Bristol, paragraph 29.

¹⁴ [Completed acquisition by Pennon Group plc of Bristol Water Holdings UK Limited](#), [ME/6946/21] (**Pennon/Bristol**) and [Anticipated acquisition by Severn Trent Plc of Dee Valley Group plc](#), [ME/6629/16] (**Severn Trent/Dee Valley**)

¹⁵ This does not include Bristol Water (BRL), which is a separate regulatory comparator.

- (a) **Wholesale base costs** are routine, year-on-year costs, which water companies incur in the normal provision of a base level of service to customers.
 - (b) **Wholesale enhancement costs** are costs to enhance the capacity or quality of service beyond a base level.
 - (c) **Residential retail costs** are incurred by water companies in delivering retail services, such as customer service costs, billing and meter reading to residential customers.¹⁶
33. Ofwat also relies on a comparative assessment across water companies to set targets for certain performance commitments (**PCs**). PCs relate to particular performance targets Ofwat sets water companies on areas such as leakage, supply interruptions and service quality. Ofwat uses outcome delivery incentives (**ODIs**), which are monetary penalties and rewards, to incentivise companies to reach and exceed the levels it sets for these PCs.
34. In addition to its assessment of the impact of the Merger in relation to the factors set out above, the CMA has also considered whether the Merger would give rise to RCBs.¹⁷
35. The CMA has considered submissions made by Pennon, including modelling undertaken by its economic advisors Oxera,¹⁸ before Pennon accepted that the test for a reference of this Merger is met.¹⁹ The CMA has also taken Ofwat's opinion of the Merger into account, as well as third-party views.
36. In relation to whether Ofwat could amend its approach to reduce the impact of the loss of a comparator, the CMA did not receive any submissions from either Pennon or Ofwat. In addition, in Pennon/Bristol, the CMA concluded that there was a realistic prospect that a change in Ofwat's approach would not be sufficient to remove the likelihood of prejudice to its ability to make comparisons between water enterprises.²⁰ In light of the above, the CMA has not seen evidence that Ofwat could amend its approach to reduce the impact of a loss of a comparator. Therefore, the CMA has not considered this further in this decision.

¹⁶ Ofwat will follow the same approach during its current price review (PR24).

¹⁷ At Phase 1, the CMA may decide not to make a merger reference under section 32 of WIA91 if it believes that the RCBs in relation to the water merger outweigh any prejudice to Ofwat's ability to make comparisons.

¹⁸ Where the CMA refers to submissions made by Oxera, these should be interpreted as referring to submissions on behalf of Pennon.

¹⁹ See paragraph 19 above.

²⁰ [Pennon/Bristol](#), paragraph 168.

ASSESSMENT OF IMPACT ON OFWAT'S ABILITY TO MAKE COMPARISONS BETWEEN WATER ENTERPRISES

Wholesale water base costs

37. In this section, the CMA considers:
- (a) The impact of the Merger on the precision of the models that Ofwat uses to set companies' cost allowances; and
 - (b) The impact of the Merger on the resulting cost allowances set by Ofwat (both at the industry level and for each water company).

Precision

38. The precision of Ofwat's econometric modelling, which Ofwat uses for determining companies' cost allowances, affects the confidence Ofwat has on the results of the wholesale base cost models.
39. There are two ways in which the Merger may have an adverse impact on the precision of Ofwat's econometric modelling:^{21,22}
- (a) The loss of an independent data point for statistical analysis. A standard principle of statistical theory is that fewer data points will lead to less precise econometric estimates.
 - (b) The Parties may have specific characteristics meaning that their data provides useful variation in key cost drivers across companies, and some of this variation is lost as a result of the Merger, resulting in a loss of precision.
40. The CMA has considered three methods to estimate the loss in precision:²³
- (a) The General approach, which measures the loss in precision related to the loss of a data point. This approach does not take account of the specific parties to a merger.²⁴

²¹ [Pennon/Bristol](#) paragraph 84.

²² The CMA considers that the impact from the loss of a comparator may be expected to increase for each successive merger that occurs, as fewer comparators would remain.

²³ The CMA notes that it previously also considered (i) a Bootstrapping approach in [Pennon/Bristol](#), in the [Completed acquisition by Pennon Group plc of Sembcorp Bournemouth Water Investments Limited](#), [ME/6532/15], ([Pennon/Bournemouth](#)), and Severn Trent/Dee Valley; and (ii) a Statistical approach in [Pennon/Bristol](#). However, the Parties submitted that they did not consider these approaches in their assessment of the impact of the Merger because (i) these approaches were not given any weight in past CMA assessments; and (ii) the Statistical approach would not provide additional information that is not already provided by the General approach. As such, the CMA has not considered these approaches in its assessment.

²⁴ [Pennon/Bristol](#) paragraph 87(a).

- (b) The Specific approach, which measures the loss in precision by re-estimating Ofwat's models under a simulation of a proposed merger (at both an industry-wide level and company level).²⁵
- (c) A Qualitative approach, which examines whether there is likely to be a loss of variation in the data used in Ofwat's models, and how this might affect their precision.²⁶

Pennon's submissions

41. Pennon submitted that the overall impact on precision deriving from the Merger is limited and smaller than the impact on precision that previous mergers in the water industry have had (eg Pennon/Bristol).²⁷ This is based on an analysis of the general approach, specific approach and qualitative approach.

- (a) General approach: Oxera estimated the reduction in the number of observations would reduce Ofwat's wholesale models' precision by [0-5]% using PR24 models, although Pennon also highlighted that this approach does not account for the characteristics of the Parties.^{28,29}
- (b) Specific approach: Oxera estimated the impact of the Merger using PR24 models both at the industry level and also at the company level.
 - (i) Industry level analysis: Oxera's modelling assessed the change in Ofwat's models' confidence intervals as a result of the Merger, where an increase in confidence intervals is interpreted as a detriment in precision and a reduction is interpreted as a benefit. Oxera submitted that:
 - (1) Confidence intervals decreased for [X] out of 24 models in Ofwat's PR24 modelling suite when simulating the Merger over the last five years.³⁰
 - (2) Confidence intervals decreased for [X] out of 24 models when simulating the Merger over the last eleven years (the full period used by Ofwat for the estimation of its PR24 models).³¹

²⁵ [Pennon/Bristol](#) paragraph 87(a).

²⁶ [Pennon/Bristol](#) paragraph 96.

²⁷ Merger Impact Assessment, paragraph 1.18.

²⁸ The same methodology using PR19 models in Pennon/Bristol indicated a detriment of [0-5]%, which Oxera submitted is a good proxy for the impact of this Merger.

²⁹ Merger Impact Assessment, paragraphs 4.50-4.52.

³⁰ Merger Impact Assessment, Annex A1: the estimated impact of the Pennon/SES merger, Table 3.1

³¹ Merger Impact Assessment, Annex A1: the estimated impact of the Pennon/SES merger, Table 3.1

- (3) On average across all models, the confidence intervals reduced by [5-10]% over the five-year period and by [5-10]% over the eleven-year period.³²
- (ii) Company level analysis: Oxera estimated the impact of the Merger on the confidence interval for each company-model combination (ie each of the 15 water companies separately and the Merged Entity, and each of the 24 models included in Ofwat’s PR24 modelling suite). Oxera submitted that:
 - (1) Confidence intervals reduced in [40-50]% of the company-model combinations.³³
 - (2) Aggregating the variation in confidence intervals across all models, [3] out of 16 companies observed a reduction in confidence intervals.^{34,35}
 - (3) There was very little change in absolute variation of confidence intervals.³⁶
- (c) Qualitative approach: Oxera estimated the impact of the Merger on the variation of costs drivers used in Ofwat’s PR24 models and analysed how this variation affects the regression coefficients.³⁷ Oxera submitted that:
 - (i) The variation (measured in terms of between company standard deviation) increased for [3] to [3] of the 15 cost drivers used in Ofwat’s PR24 models,³⁸ where an increase could be considered as a potential gain in precision.³⁹
 - (ii) The largest changes in coefficients are observed in the case of density variables. However, this impact is not driven by a reduction in variation of the variables. Instead, these variations can be explained by the lower (pre-Merger) precision of the estimates.⁴⁰

³² Oxera submitted that, for comparison, confidence intervals reduced by [0-5]% on average in Pennon/Bristol. Merger Impact Assessment, Annex A2: precision impact, page 16

³³ Pennon’s response to the CMA’s Request for Information, 16 February 2024 (RFI 1) Annex 1, page 4

³⁴ Oxera has followed Ofwat’s triangulation approach at PR19 to aggregate results at the company level.

³⁵ Pennon’s response to RFI 1, Annex 1, page 5

³⁶ Pennon’s response to RFI 1, Annex 1, pages 6-8

³⁷ The analysis of the change in regression coefficients provides a qualitative explanation as to what might be found in terms of the impact on the cost assessment models due to a loss in information on cost drivers. Merger Impact Assessment, paragraph 4.77.

³⁸ Variation increased for nine out of 15 cost drivers if the Merger is modelled by combining SWB and SES into one entity and variation increases for 12 out of 15 cost drivers if the Merger is modelled by dropping SES.

³⁹ Merger Impact Assessment, Annex A2: precision impact, page 20

⁴⁰ Merger Impact Assessment, paragraph 4.81.

Ofwat's submissions

42. Ofwat submitted that the Merger is expected to result in a loss of precision of the econometric models used for its assessment of wholesale base costs. For some companies, this loss in precision is significant and is likely to result in a material impact on their cost allowance.⁴¹
- (a) General approach: Ofwat agreed with the magnitude of the impact estimated by the Parties. Ofwat also submitted that the General approach provides a useful alternative view to the Specific approach as it is less sensitive to the specific data and models used, and thus more robust to changes over time.⁴²
 - (b) Specific approach: Ofwat submitted that company level analysis is more relevant than industry level analysis, as Ofwat aims to set the costs accurately for each company, not just on average for the sector. Ofwat also submitted that conclusions on the precision of models at industry level disregard potential detrimental impacts on individual companies.⁴³ Ofwat replicated the company level precision analysis and submitted that:⁴⁴
 - (i) The precision of [50-60]% of company-model predictions deteriorates.
 - (ii) For [X] of the 15 companies examined, precision deteriorates in at least [70-80]% of models.
 - (iii) In comparison to the sector level analysis, the company level analysis results in more instances of deterioration, as well as in higher materiality of deterioration.⁴⁵
 - (iv) [X] of the 15 companies examined experienced an absolute increase in confidence interval of [0-5]% or more.⁴⁶ A widening of models' confidence interval by over [0-5]% is material as (i) it can have material implications on companies' cost predictions; and (ii) it can significantly increase the volume of analysis that Ofwat would need to do to complement its benchmarking models' results.

⁴¹ Ofwat's Opinion on Pennon's acquisition of SES submitted to the CMA on 25 March 2024 (**Ofwat's Opinion**), paragraphs 1.5.

⁴² Ofwat's Opinion, paragraphs 3.15-3.16.

⁴³ Ofwat's Opinion, paragraphs 3.17.

⁴⁴ Ofwat's Opinion, paragraphs 3.18-3.24.

⁴⁵ The deterioration in precision does not exceed [5-10]% under the sector level analysis, but the company level analysis finds several instances where companies face a deterioration of over [5-10]%.

⁴⁶ Note that (1) the relative change is calculated by dividing the change in confidence intervals by the pre-merger confidence interval; and (2) absolute changes simply reflect the changes in confidence intervals. Absolute changes appear in percentage terms because the confidence intervals themselves are calculated as a percentage of the predicted costs.

CMA assessment

43. The CMA has previously noted that the analysis of the impact on precision is not simple to interpret and requires thorough investigation.⁴⁷ In some circumstances, the Specific Approach might yield the counter-intuitive result that the loss of a data point caused by a merger 'increases precision', in the narrow sense that estimated standard errors and confidence intervals are narrower. This can happen if the merged entity has a cost profile 'closer to the average' than the separate entities. However, this mechanical implication of the merger does not necessarily mean that the resulting estimates are more robust or insightful from the point of view of the regulator. If two companies with similar operational profiles have very different costs (resulting in large standard errors and confidence intervals in the regression), this might in fact be an interesting observation for the regulator. It might imply that there are substantial differences in the efficiency levels of firms, or that the model leaves out some important cost drivers. Put differently, combining some data points might make the model appear more robust and comprehensive than it actually is. The CMA has previously found that these limitations meant that, in the context of a Phase 1 inquiry, it is more appropriate to place weight on the General approach, which only considers the impact on precision of a change in the sample size. The General approach always points to a reduction in precision, but that reduction can be more or less substantial given the circumstances of the case.
44. Notwithstanding these reservations, the CMA has considered the evidence submitted by the Parties and Ofwat. In particular:
- (a) In relation to the General approach, Ofwat and Oxera agreed on the methodology for estimating the impact on precision and found a detriment to model precision of around [0-5]%.
 - (b) In relation to the Specific approach at company level, Ofwat and Oxera followed the same methodology for estimating the impact on precision and generated almost the same results from their respective analyses. Both found an increase in confidence intervals in more than half the company/model cases considered. Oxera and Ofwat submitted differing views on: (i) the proportion of cases in which precision deteriorated;⁴⁸ and (ii) the materiality of deterioration in precision.⁴⁹ The CMA also notes that Oxera's analysis at the industry level estimated a detriment in over [3<] of the models considered.

⁴⁷ [Pennon/Bournemouth](#), paragraph 6.89 and [Pennon/Bristol](#) paragraph 108.

⁴⁸ Ofwat estimated that precision reduced in [50-60]% of cases considered whereas Oxera estimated a reduction in precision in [50-60]% of cases. Ofwat and Oxera calculate the same estimates of the precision impact in cases where they both find a reduction in precision.

⁴⁹ Ofwat submitted that a change in precision of more than [0-5]% (considering absolute variation) is material, whereas Oxera submitted that the confidence interval [3<].

(c) In relation to the Qualitative submissions, Ofwat did not make any submissions, whereas Oxera's analysis indicated that the variation decreased for [X] to [X] of the 15 cost drivers used in Ofwat's PR24 models.

45. As the General approach is relatively simpler to interpret compared to other approaches which require a more thorough investigation, the CMA considers that, at least in the context of a Phase 1 inquiry, it is appropriate to place more weight on the General approach. The CMA also notes that the Specific and Qualitative approaches indicate a detriment in a significant number of cases considered.
46. Based on the evidence above, the CMA considers that there is a realistic prospect that that the Merger may lead to a loss of precision thus prejudicing Ofwat's ability to carry out its functions to use comparative regulation.

Cost allowances

47. In this section, the CMA considers whether the loss of a comparator resulting from the Merger could affect Ofwat's ability to make comparisons by removing a high or low performing company from Ofwat's set of comparators, which could:
- (a) Change the efficiency benchmark and, in turn, the total industry cost allowance; or
 - (b) Impact the precision of individual companies' cost predictions resulting in under or overfunding of individual companies.⁵⁰
48. The CMA has considered both the static approach (which assesses what the impact of the Merger would have been if the Merger had occurred prior to the last price control) and the forward-looking approach (which takes account of possible impacts in future price controls).⁵¹

Pennon's submissions

49. In relation to the industry cost allowance, Pennon submitted that the Merger would lead to a more stringent industry benchmark, given that its modelling found the impact of the Merger on the cost benchmark to be beneficial in [80-90]% of scenarios. Pennon submitted this is because SES has below sector average cost performance and SWB has efficient cost performance, which means the Merged

⁵⁰ This is due to the change (arising from the Merger) in cost data used by Ofwat to make these predictions.

⁵¹ See [Ofwat's approach to mergers and statement of methods](#), page 13. The static approach has been analysed using Ofwat's PR24 models (which have been available since April 2023) as they constitute the most up to date information available at the time of the Merger assessment.

Entity would most likely be an efficient company.⁵² In particular, Pennon submitted that:

- (a) Using the static approach, there is a net benefit in [X] of the 44 scenarios considered (of up to £[X]).^{53,54iii} The [X] scenarios that estimate a net detriment (of up to £[X]) relate to historic periods in which the Pennon/BWH merger had not yet fully materialised and are therefore less likely to be representative of SWB's efficiency going forward.⁵⁵
- (b) The forward-looking approach indicates that the Merger would lead to a benefit in [X] scenarios considered⁵⁶ of between £[X] and £[X].^{57,58}

50. In relation to companies' cost predictions, Pennon submitted that although its modelling found a change in cost predictions of more than [0-5]% for [X] companies, the long-term variation as a result of the Merger is generally small.⁵⁹

Ofwat's submissions

- 51. Ofwat submitted that the Merger could lead to a detrimental impact on the efficiency benchmark with higher prices for customers across the sector due to the loss of SWB as an efficient independent comparator. However, Ofwat noted that the risk of a material detriment to the cost efficiency benchmark is not high given that SES is small relative to SWB.⁶⁰
- 52. Ofwat also submitted that instances in which Oxera's analysis shows a benefit (under both the static and forward-looking approach)⁶¹ are not driven by a genuine improvement in observed efficiencies among leading companies but are due to a 'formula effect' arising from Oxera's methodology for calculating the benchmark. In particular, Ofwat submitted that:

⁵² Merger Impact Assessment, paragraph 1.18.

⁵³ Oxera considered a number of scenarios under a static approach by (i) testing different benchmark assumptions (ie upper quartile or upper quintile); or (ii) by testing different time periods for the modelling; or (iii) by testing different assumptions on the treatment of water companies that merged during the modelling period (eg Severn Trent/Dee Valley or South West Water/Bournemouth Water).

⁵⁴ Merger Impact Assessment, Annex A3: cost benchmark impact, Table 3.2 – Table 3.4

⁵⁵ Merger Impact Assessment, Annex A3; cost benchmark impact, Page 33

⁵⁶ Oxera considered a number of scenarios under the forward-looking approach by (i) testing different assumptions on the efficiency rankings of water companies at future price controls; and (ii) by testing different assumptions on the treatment of water companies that merged during the modelling period.

⁵⁷ Merger Impact Assessment Annex A3: cost benchmark impact, Section 4.3.4

⁵⁸ Oxera also submitted that these results are consistent with a qualitative assessment of the forward-looking approach which found that the current efficiency rankings performance of SWB and SES were likely to persist over the next few price controls. The qualitative assessment assesses the gap between the respective efficiency positions of SWB, SES and the Merged Entity and the upper quartile or upper quintile efficiency benchmarks at various points within the previous price controls. It finds that (i) SWB is typically above the efficiency benchmark; (ii) SES is always below the efficiency benchmark; and (iii) the Merged Entity (assumed to be the weighted average of SWB and SES) is typically above the efficiency benchmark.

⁵⁹ Pennon submitted that, for comparison, in Pennon/Bristol, [X] companies faced a variation of more than [0-5]%. Merger Impact Assessment, paragraph 1.18.

⁶⁰ Ofwat's Opinion, page 19-20.

⁶¹ Ofwat's Opinion, paragraph 3.49

- (a) Oxera used the 'upper quartile' as the efficiency benchmark, which means that when the number of comparators reduces from 17 to 16 as a result of the Merger, the benchmark puts more weight on the fourth most efficient company and less on the fifth most efficient company and therefore becomes more stringent as a result of this formula effect.⁶²
- (b) An efficiency benchmark that is based on the efficiency of leading companies can either become less stringent or be unaffected by a merger. In this case, Ofwat noted that losing SWB as an independent comparator and replacing it with the Merged Entity, where its efficiency is averaged with SES' inefficiency, is harmful as it inevitably results in a lower level of efficiency amongst the sector's most efficient companies.⁶³

53. Ofwat also submitted that it does not set the efficiency benchmark mechanistically but instead considers various factors in deciding the efficiency benchmark (including whether the benchmark provides a reasonable challenge for companies in the sector). In the past, Ofwat has used efficiency benchmarks other than the upper quartile such as the median or a specific companies' efficiency level (eg the fourth company at PR19)⁶⁴ and it noted that its approach to price controls and setting efficiency benchmarks may evolve over time.⁶⁵

CMA assessment

- 54. In relation to companies' cost predictions, Oxera's modelling found a change in cost predictions of more than [0-5]% for [X<] of the 16 companies considered, and for some companies the change was much higher than [0-5]% (eg predicted costs decreased by more than [5-10]% for [X<]).
- 55. One third party also told the CMA that reducing the number of companies in the short to medium term could reduce the quality of Ofwat's data sample and in turn adversely affect Ofwat's ability to properly set totex allowances in a reliable way.⁶⁶
- 56. Further, the CMA notes that Oxera's results in relation to the industry cost allowance assume that Ofwat will use an upper quartile or upper quintile efficiency benchmark. However, as discussed at paragraph 53 above, Ofwat has used a range of different efficiency benchmarks in the past.⁶⁷ The CMA therefore considers that modelling results based only on the upper quartile and upper

⁶² Ofwat's Opinion, paragraphs 3.41 – 3.43.

⁶³ Ofwat's Opinion, paragraphs 3.37 – 3.38.

⁶⁴ Ofwat's Opinion, paragraph 3.46.

⁶⁵ Ofwat's Opinion, paragraph 3.44.

⁶⁶ Submission to the CMA from a third-party, March 2024

⁶⁷ For the avoidance of doubt, the CMA has not seen evidence that changes to the efficiency benchmarks used (or other changes in Ofwat's approach) could reduce the impact of the loss of a comparator (see paragraph 36 above).

quintile may not be fully reflective of the potential detriment arising from the Merger.

57. Based on the evidence set out above, the CMA considers that there is a realistic prospect that the Merger may have a detrimental impact on the industry base cost allowance and on individual companies' base cost predictions.

Wholesale Enhancement costs

Pennon's submissions

58. Pennon submitted that the majority of water enhancement costs are covered by deep dives and shallow dives, and so are not affected by the Merger.^{68,69} Pennon further submitted that, while enhancement cost models for PR24 are currently unknown, these costs only relate to a minor share of companies' cost base. Any impact from the Merger is thus likely to be far smaller than the base cost impact.⁷⁰

Ofwat's submissions

59. Ofwat submitted that it uses comparative assessment to assess and challenge enhancement investment proposals where possible and that it plans to make greater use of benchmarking in assessing enhancement costs at PR24.⁷¹
60. Ofwat submitted that enhancement models are less precise than base models due to the irregular and lumpy nature of enhancement expenditure. It also submitted that comparisons are often based on a sub-sample of companies. Ofwat explained that this means that the value of a given comparator is potentially even greater than for wholesale base costs (eg because enhancement cost models have fewer data points compared to base cost models so losing a data point would have greater impact).⁷²
61. Ofwat concluded that the Merger is likely to prejudice its ability to make comparisons when assessing enhancement expenditure from PR29 onwards.⁷³

CMA assessment

62. The CMA considers that having more comparators may enable Ofwat to better assess enhancement costs, particularly as it aims to make greater use of

⁶⁸ Merger Impact Assessment, paragraph 1.16.

⁶⁹ For activities that are not undertaken by most companies or where benchmarking is not possible and the total expenditure is relatively small, Ofwat adopts a deep dive or shallow dive approach. These involve a range of approaches, for example specific unit costing and bottom-up methods.

⁷⁰ Merger Impact Assessment, paragraph 4.5.

⁷¹ Ofwat's Opinion, paragraphs 3.53-3.54.

⁷² Ofwat's Opinion, paragraphs 3.55-3.57.

⁷³ Ofwat's Opinion, paragraphs 3.59.

benchmarking in future. For this reason, the CMA considers that the Merger could lead to a detriment in Ofwat's ability to assess enhancement costs.

Residential retail costs

Pennon's submissions

63. Pennon submitted that retail costs account for a small part of water companies' total costs,⁷⁴ and that most retail costs can be compared with benchmarks outside the water sector. Pennon further submitted that, while the latter point does not apply to bad debt costs, these equate to only 10% of wholesale water base costs, such that any impact from the Merger is likely to be far smaller than the base cost impact.⁷⁵ However, Pennon also submitted that some of SES' retail characteristics may be of use to Ofwat in its cost assessment.⁷⁶

Ofwat's submissions

64. Ofwat accepted Pennon's arguments for putting less weight on the assessment of the Merger's impact on residential retail cost comparisons. However, Ofwat also submitted that using benchmarks from outside the water sector can be difficult due to comparability issues, and the use of external benchmarks has to date been very limited.⁷⁷

65. Ofwat also submitted that its main concern in residential retail relates to bad debt, which represents a significant share of total retail costs, and is less comparable with other sectors. Ofwat further explained that SES' low average bill together with its low income deprivation score are likely to be important for the precision and robustness of its bad debt models, in particular for companies with similar characteristics.⁷⁸

66. Ofwat concluded that as the Merger would lead to the removal of the SES data points, it is likely to prejudice its ability to set residential retail costs through comparisons.⁷⁹

CMA assessment

67. The CMA considers that SES' characteristics in relation to average bill size and deprivation score may be important for Ofwat in estimating bad debt, and therefore

⁷⁴ Merger Impact Assessment, paragraph 1.16.

⁷⁵ Merger Impact Assessment, paragraph 4.5.

⁷⁶ Merger Impact Assessment, paragraph 1.18.

⁷⁷ Ofwat's Opinion, paragraph 3.65.

⁷⁸ Ofwat's Opinion, paragraphs 3.66-3.67.

⁷⁹ Ofwat's Opinion, paragraph 3.68.

retail costs. For this reason, the CMA considers that the Merger could lead to a detriment to Ofwat's ability to regulate the cost of residential retail activities.

Performance commitments and outcome delivery incentives

68. In this section, the CMA considers the impact of the Merger on Ofwat's ability to set PCs and use ODIs.⁸⁰

Pennon's submissions

69. Pennon submitted that although SES is an industry leader on several PCs, the impact of the Merger is limited.⁸¹

70. Oxera carried out a static assessment of the impact of the Merger on several PCs.⁸² First it estimated the upper quartile and/or median performance resulting from the Merger, which it assumed would be the level of the PC in that scenario. Then it compared this with the PC level absent the Merger and quantified the impact in monetary terms using the PR19 ODI rates. This resulted in a benefit where Oxera estimated that the Merger would lead to more stringent PC levels, and detriment where Oxera estimated the Merger would lead to less stringent PC levels. In its analysis, Oxera considered various time periods, but focused on the latest outturn of data (up to 2022/23) and on companies' projected performance by the next price review, PR29 (2029/30).⁸³

71. Oxera submitted that, although the results are sensitive to (i) the period assessed, and (ii) the benchmark assumed, they are similar to those presented at the time of the Pennon/Bristol merger.⁸⁴ For example, Oxera's analysis shows that the results vary from a benefit of £[>] (per capita consumption) to a detriment of £[>] (mains repairs).⁸⁵

72. Oxera also aggregated the net impact across all the PCs considered. In particular, Oxera found: for the 2022/23 scenario, a net benefit of £[>] excluding mains repairs,⁸⁶ and a net detriment of £[>] including mains repairs; for the 2029/30

⁸⁰ See paragraph 33 for details on Ofwat's use of PCs and ODIs.

⁸¹ Merger Impact Assessment, paragraph 4.29.

⁸² Including water supply interruptions, leakage, per capita consumption, water quality contacts, main repairs, and unplanned outages.

⁸³ Merger Impact Assessment, paragraphs 4.38-4.41.

⁸⁴ For each PC, Oxera considered a number of scenarios by (i) testing different time periods (2019/20, 2021/22, 2022/23 (3 year average), 2029/2030) and (ii) testing different benchmarks (upper-quartile or median).

⁸⁵ Oxera's estimate of a benefit of £[>] in relation to per capita consumption is calculated using data for 2022/23 and is based on the upper-quartile benchmark. Detriment of £[>] in relation to mains repairs is calculated using data for 2022/23 and is based on median as the benchmark.

⁸⁶ Oxera noted that for PR24 Ofwat will set a company-specific target for main repairs and that any merger impact assessment for this metric is thus 'only notional' (see Merger Impact Assessment, paragraph 4.33).

scenario, a net benefit of £[<] for excluding mains repairs, which increases to £[<] when including mains repairs.⁸⁷

73. Oxera also submitted that, despite SES being an industry leader on several PCs, it is unlikely that the Merger would result in a significant detriment to Ofwat's comparative regime, given that: (i) at PR19 only water supply interruptions were a 'strictly comparative upper quartile measure'; (ii) SWB is catching up with SES based on recent performance; (iii) the quantified detriment is generally not material; and (iv) based on company business plan forecasts, industry-wide performance is expected to converge absent the Merger and therefore the impact reduces over time.⁸⁸

Ofwat's submissions

74. Ofwat submitted that the Merger is expected to have a detrimental impact on several PC levels. This is because SES has been a high performer in many service areas and therefore the loss of SES as an independent comparator could result in less stringent PC levels across the sector.⁸⁹
75. Ofwat also submitted that although Oxera's assessment is a simplification, its results show detriments likely to prejudice Ofwat's ability to set stretching and appropriate PCs using comparisons.⁹⁰
76. Ofwat further submitted that:⁹¹
- (a) A merger cannot be beneficial for the setting of PC levels. As a merger leads to the replacement of two independent comparators with a single one that is an average of the two, observations on top performance in the sector – which Ofwat uses to set PC levels – will necessarily be reduced (if at least one merging company is a strong performer) or unaffected (if both merging companies are poor performers). Although Oxera also estimated benefits, this is merely a product of the way the upper quartile or median is calculated (ie due to the smaller sample, rather than relating to SWB or SES specifically).⁹²
 - (b) While there has been industry-wide convergence in outcomes in terms of unplanned outages, there has not been a clear (or any) convergence on other outcomes. Therefore, due weight should be placed on historical results, not only on the most recent period, (ie up to 2022/23). Moreover, it is not

⁸⁷ Merger Impact Assessment, paragraph 4.43.

⁸⁸ Merger Impact Assessment, paragraph 4.45.

⁸⁹ Ofwat's Opinion, paragraph 1.5.

⁹⁰ Ofwat's Opinion, paragraphs 4.11-4.13.

⁹¹ Ofwat's Opinion, paragraphs 4.15-4.20.

⁹² Ofwat noted, for example, that the upper quartile performance in the sector would become more stretching even if the only change made is the removal of a poor performing company.

appropriate to put more weight on results based on forecast, business plan performance (ie the 2029/30 scenario) over results based on actual performance.

- (c) It is not appropriate to aggregate estimated benefits and detriments across all outcomes (see paragraph 72 above). This is because each outcome is important for customers and Ofwat aims to push companies to improve their performance on each and every outcome.
- (d) The Oxera results are based on a mechanistic approach, whereas Ofwat does not apply a mechanistic approach when setting PC levels, and considers various factors, such as a company's past performance and any relevant company-specific circumstances.

CMA assessment

- 77. Both Pennon and Ofwat described SES as an industry leader in several service areas. Moreover, Oxera's analysis suggests that, under several scenarios, the Merger could lead to detriment in relation to several PCs. The CMA has also not seen sufficient evidence to show that SWB's, SES' and the other water companies' performance will converge to the extent that the Merger would not have an impact.
- 78. One third party also told the CMA that the loss of SES will affect how Ofwat will be able to use PCs and ODIs for its system of comparative regulation.⁹³
- 79. The CMA therefore considers that the loss of SES as an independent comparator could adversely impact Ofwat's ability to use PCs and ODIs as part of its comparative regulation of the market.

Relevant customer benefits

- 80. Under the special water regime, if the CMA finds that a Merger has prejudiced/is likely to prejudice Ofwat's ability to make comparisons between water enterprises, then it may consider whether this prejudice is outweighed by **RCBs**.
- 81. RCBs are limited to benefits to 'relevant' customers in the form of: (a) lower prices, higher quality or greater choice of goods or services in any market in the UK; or (b) greater innovation in relation to such goods and services.⁹⁴ Relevant customers are customers of the merging enterprises at any point in the chain of production

⁹³ Submission to the CMA from a third-party, March 2024

⁹⁴ [CMA49](#), paragraph 5.3.

and distribution and are therefore not limited to final consumers, and include future customers.⁹⁵

82. In addition to falling within the description of RCBs, the CMA must believe that the benefit has accrued as a result of the merger or is expected to accrue within a reasonable time period as a result of the merger, and that the benefit was, or is, unlikely to accrue otherwise.⁹⁶
83. The CMA will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit.⁹⁷ In order to reach a finding that benefits arising from a merger may outweigh any prejudice, the CMA would have to be persuaded on the basis of compelling evidence that such benefits were merger-specific, realistic, and would be passed through to customers.⁹⁸

Pennon's submissions

84. Pennon submitted that the Merger will deliver significant benefits for customers and for the sector.⁹⁹ These included:¹⁰⁰
- (a) Delivering lower bills to customers through (i) its commitment to waive the small company premium requested by SES for PR24, and (ii) synergy savings;
 - (b) 'Enhancing the voice of the customer' through the extension of the WaterShare+ scheme;¹⁰¹
 - (c) Service improvements;
 - (d) Environmental benefits;
 - (e) Improving SES' financial resilience through a £[<] equity injection;
 - (f) Improving Ofwat's cost efficiency comparisons;
 - (g) Improving Ofwat's cost of equity assessments;

⁹⁵ [CMA49](#), paragraph 5.4.

⁹⁶ [CMA49](#), paragraph 5.5.

⁹⁷ [CMA49](#), paragraph 5.6.

⁹⁸ [CMA49](#), paragraph 5.12.

⁹⁹ Merger Impact Assessment, paragraph 1.21.

¹⁰⁰ See Merger Impact Assessment, paragraphs 5.15-5.68.

¹⁰¹ South West Water describes WaterShare+ as a scheme that allows customers to share their views with South West Water and to have a financial stake in the business by becoming shareholders (see [WaterShare+ | South West Water](#)). Pennon also proposed to share a proportion the financial efficiency savings of the Merger with its customers through the WaterShare+ scheme.

- (h) Increasing the presence of investors with a long-term focus on the water sector (ie Pennon's presence); and
- (i) Increasing governance, transparency and openness given Pennon is a listed company.

Ofwat's submissions

85. Ofwat recognised that some benefits put forward by Pennon may qualify as potential RCBs. However, Ofwat also submitted that it is not clear that these are certain and/or that their value is not as high as estimated by Pennon. Ofwat further submitted that, overall, the benefits that could constitute RCBs would in any event not outweigh the prejudice to Ofwat's ability to make comparisons that arises from the Merger.¹⁰²
86. Ofwat also provided views on each of the benefits put forward by Pennon. In particular, Ofwat submitted that:¹⁰³
- (a) there is insufficient evidence to support Pennon's submissions that the Merger will deliver lower bills to customers and enhance their voice;
 - (b) the service improvements, environmental benefits, improvements in financial resilience and improvements in cost efficiency comparisons put forward by Pennon are not Merger-specific;
 - (c) the Merger will not have an impact on Ofwat's cost of equity assessments; and
 - (d) Pennon did not explain how the Merger would lead to better outcomes in relation to the presence of investors with a long-term focus on the water sector, as well as on governance, transparency and openness.

CMA assessment

87. As explained above, RCBs are limited to merger specific benefits to customers of the merging parties in the form of: (a) lower prices, higher quality or greater choice of goods or services; or (b) greater innovation in relation to such goods and services. Moreover, they need to be supported by compelling evidence (see paragraphs 81-83 above).
88. The CMA considers that several of the benefits put forward by Pennon: are not Merger specific, that is they could have potentially accrued absent the Merger (eg the improved financial resilience); are not specific to the Parties' customers (as for

¹⁰² Ofwat's Opinion, paragraph 5.6.

¹⁰³ Ofwat's Opinion, paragraphs 5.7-5.47 and Table 3.

all the ‘benefits for the sector’ put forward); and/or are not clearly in the form of lower prices, higher quality or greater innovation (eg the increased presence of investors with a focus on water). In addition, although some benefits put forward by Pennon may qualify as potential RCBs, the CMA has not seen compelling evidence to support them.

89. In the round, the CMA therefore considers that there is insufficient evidence to conclude at Phase 1 that the potential RCBs would outweigh the adverse impacts of the Merger.

Consumer views

Pennon’s submissions

90. Pennon submitted that the customer research it had undertaken on SES’ customers (including focus groups and in-depth interviews) shows that SES’ customers support the benefits that mergers can deliver. The research also found, for example, that customers consider SES’ performance on the whole to be good, that they should be able to have a say on how their local water company operates, they see innovation as important and were concerned to hear that SES is one of the most indebted companies in the sector. Although customers did not raise concerns about the Merger, they considered that bills would need to reduce as a result and service would need to continue to be good.¹⁰⁴

Ofwat’s submissions

91. Ofwat submitted that, while customer views may be useful to highlight areas of concern or provide insight on whether they value their water company remaining independent, customers cannot be expected to provide an informed view on how a merger may impact Ofwat’s ability to use comparisons. Ofwat further submitted that the evidence on customer support does not change its view that the prejudice on its ability to regulate through comparisons is not outweighed by RCBs.¹⁰⁵

CMA assessment

92. The CMA considers that customer research, if properly conducted, may be informative of consumer views. However, the CMA does not consider that this evidence is relevant for the purpose of informing any assessment of the statutory question, ie whether the Merger results in prejudice to Ofwat’s ability to make comparisons between water enterprises, and whether any relevant customer benefits outweigh that prejudice.

¹⁰⁴ Merger Impact Assessment, paragraphs 5.5-5.14. See also: Pennon’s response to RFI 1, paragraphs 3.7-3.10.

¹⁰⁵ Ofwat’s Opinion, paragraphs 6.4-6.7.

Third-party views

93. The CMA issued an invitation to comment and received submissions from interested third parties. The CMA carefully reviewed all submissions made by third parties and took these into account in its assessment of the Merger.

DECISION

94. For the reasons set out above, the CMA believes that there is a realistic prospect that the Merger has prejudiced or will prejudice Ofwat's ability to make comparisons between water enterprises. Accordingly, the CMA considers that it is not appropriate to apply the exception under s.33A(2)(a) of the WIA, ie the CMA does not believe that the Merger 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.
95. In addition, the CMA considers that the prejudice set out above will not be outweighed by RCBs relating to the Merger. Accordingly, it does not consider that it should decide not to make a reference on the grounds that it believes that the Merger has prejudiced or is likely to prejudice Ofwat's ability, but that the prejudice in question is outweighed by RCBs relating to the merger.
96. The CMA therefore believes that it is under a duty to refer the Merger under section 32 of the WIA91.
97. However, the duty to refer is not exercised whilst the CMA is considering whether to accept undertakings under section 33D of the WIA91 instead of making such a reference. Pennon has until 13 May 2024 to offer undertakings to the CMA. The CMA will refer this Merger for a phase 2 investigation if Pennon does not offer an undertaking by this date; if Pennon indicates before this date that it does not wish to offer an undertaking; or if the CMA decides by 20 May 2024 that there are no reasonable grounds for believing that it might accept the undertaking offered by Pennon, or a modified version of it.
98. The statutory four-month period mentioned in section 24 of the Act in which the CMA must reach a decision on reference in this case expires on 10 May. For the avoidance of doubt, the CMA hereby gives the Parties notice pursuant to section 25(4) of the Act that it is extending the four-month period mentioned in section 24 of the Act. This extension comes into force on the date of receipt of this notice by the Parties and will end with the earliest of the following events: the giving of the undertakings concerned; the expiry of the period of 10 working days beginning with the first day after the receipt by the CMA of a notice from the Parties stating that it does not intend to give the undertakings; or the cancellation by the CMA of the extension.

Joel Bamford
Executive Director, Mergers
Competition and Markets Authority
3 May 2024

ⁱ In addition to water utilities, Pennon has other activities relating to energy, including through its subsidiary Pennon Power Limited.

ⁱⁱ Each of the Parties have subsidiaries which are water undertakers appointed under Section 6 of the WIA91.

ⁱⁱⁱ The figure £[<] at paragraph 49(a) should be deleted and replaced with the figure £[<].