Ofwat's Opinion on Pennon's acquisition of SES Water

About this document

This document sets out our opinion as to whether and to what extent the merger between South West Water Limited (owned by Pennon Group plc) and Sutton and East Surrey Water plc has prejudiced or is likely to prejudice our ability to make comparisons between water enterprises in carrying out our functions, and whether that may be outweighed by relevant customer benefits relating to the merger.

Contents

1. Executive Summary

1.1 On 10 January 2024 Pennon Group plc (**Pennon**), which owns South West Water Limited (**SWB**), acquired 100% of the issued capital of Sumisho Osaka Gas Water UK Limited, the holding company of Sutton and East Surrey Water plc (**SES Water** or **SES**) and certain other ancillary businesses.[1] SWB and SES Water are appointed undertakers in England for, respectively, water and sewerage, and water only services. The effect of the merger is therefore to combine two companies that provide water services in England. Throughout the document, we refer to this merger as the **SES Merger**.

1.2 Mergers between water enterprises are in certain circumstances subject to a special water merger control regime. Under the Water Industry Act 1991 (**WIA91**), our role in that merger control process is to provide an opinion to the CMA on whether the merger has prejudiced or is likely to prejudice our ability to make comparisons between water enterprises, and whether the prejudice in question is outweighed by any relevant customer benefits (**RCBs**).[2]

1.3 Pennon and its consultants, Oxera, have engaged with us at the pre-notification stage to discuss the merger and its anticipated impact.

1.4 We have reviewed the evidence submitted by Pennon, including its merger impact assessment (**MIA**),[3] and, where appropriate, carried out our own analysis in accordance with the Statement of Methods published in October 2015.[4]

1.5 We consider that the SES Merger will prejudice our ability to regulate the sector through comparisons. This prejudice can lead to detriments that will affect all water customers in England and Wales, not just those of the merged entity. In particular:

- The merger is expected to result in a **loss of precision** of our econometric models used for the assessment of base costs. For some companies this loss in precision is significant and is likely to result in a material impact on their cost allowance.

- The merger is expected to have a **detrimental impact on several performance commitment levels**. The loss of SES, which has been a high performer in many service areas and helped us set a performance benchmark for the sector, could

[1] See Pennon, January 2024, 'Pennon Group PLC acquisition of Sutton and East Surrey Water'.
[2] Section 33B WIA91.
[3] Pennon, February 2024, 'Bringing Purposeful Benefits to the Water Sector: The case for the merger of South West Water and Sutton & East Surrey Water', Version 2.0.
[4] See Ofwat, October 2015, 'Ofwat's approach to mergers and statement of methods'.

result in less stringent performance commitment levels for the sector and lower service levels for customers across the sector.

1.6 In relation to the merger impact on the cost efficiency benchmark, Oxera's analysis suggests that the merger is likely to result in a benefit because it leads to a more challenging benchmark, which in turn would lead to lower prices for customers. We do not consider that the merger can lead to a benefit in terms of our ability to set a more challenging benchmark. The efficiency benchmark is primarily informed by the most efficient companies in the sector. The merged entity will not provide evidence of greater efficiency compared to the efficiency of SWB before the merger (unless we assume significant synergy savings from the merger such that the merged entity is more efficient than SWB, which we do not consider to be the case) and therefore it does not provide a benefit in this respect.

1.7 The merger could be detrimental to our ability to set a challenging cost efficiency benchmark due to the loss of SWB, which has been a relatively efficient comparator that can help set the benchmark. We do not consider that the detriment in this area is material. While the merger leads to the loss of SWB, the merged entity is expected to have an efficiency level that is not far below that of SWB given the relatively large weight of SWB within the merged entity.[5]

1.8 Pennon submits that the merger will create some benefits for customers. We acknowledge that there are potential benefits to customers from the merger, such as some synergy savings resulting from the integration of functions. We also welcome Pennon's commitments, such as to provide an equity injection to SES. To remove SES' request for a small company premium on its cost of debt, and to extend its WaterShare+ and affordability support schemes to SES customers. However, most benefits put forward by Pennon, including the above, are uncertain and/or lack sufficient evidence and robust quantification to be considered as RCBs under the merger control regime.

1.9 While we find that the prejudice of the merger is not outweighed by RCBs, we see a prospect of resolution in Phase 1 if clear-cut undertakings in lieu (**UILs**) are offered that address the prejudice.

1.10 This document is structured as follows:

[5] Although we consider that the loss of SWB would not have a material detrimental impact on the cost efficiency benchmark, the merger can have a detrimental impact on the cost efficiency benchmark by reducing the precision of cost predictions, and therefore our confidence to use these predictions to set a stringent efficiency benchmark.

Section 2 explains the benefits of comparators and the role they play in our regulation of the sector, and the special merger regime.

Section 3 considers the impact of the merger on our ability to assess the efficient level of costs for the sector and for each company.

Section 4 considers the impact of the merger on our ability to set appropriate performance commitment levels for the companies, which are important for customers and the environment.

Section 5 sets out our view on the RCBs put forward by Pennon in its MIA.

Section 6 provides our comments on the customer survey evidence submitted by Pennon.

2. Use of comparisons in the water sector and the special merger regime

2.1 Water companies are regional monopolies. These companies are not subject to the same market forces as companies in competitive sectors. Due to the lack of competitive pressure, Ofwat regulates the sector in line with its statutory duties, in summary, to protect the interests of consumers and secure that the water companies properly carry out and are able to finance their statutory functions.[6]

2.2 To protect the interests of consumers we need to ensure that consumers' bills reflect efficient expenditure (including financing costs), and that they receive high service quality. To achieve this, we make extensive use of comparisons (ie 'benchmarking'). Benchmarking is an effective regulatory tool. It helps us to identify what good looks like, in terms of costs efficiency and quality of service, and to incentivise companies to achieve and exceed these levels.

2.3 In general, the more comparators we have, the more accurate and effective is the comparative assessment. This, in turn, allows us to discharge our duties more effectively. Some of the key applications of comparative assessment are:

- **Setting efficient cost allowances**. In a price control we set efficient cost allowances for companies for a period of five years. The level of cost allowance has very material implications for customers' bills. To set efficient cost allowances we heavily rely on benchmarking, often using econometric models. Having more comparators helps us set efficient cost allowances in at least two ways:

  - With more comparators our benchmarking analysis is likely to be more accurate and reliable. This is particularly the case for our econometric models, where we estimate the relationship between companies' costs and several external factors that differ across companies and influence the level of efficient cost.

  - With more comparators our benchmark level of efficiency is likely to be more challenging. This is because the likelihood that a small critical mass of companies achieves an efficiency level above a certain threshold, which we can use to hold companies to account, is higher the more comparators there are.

- **Setting performance commitment levels**. In a price control we set performance commitment levels (**PCLs**) for companies in various areas of performance, such as supply interruptions, water leakage, and water quality standards. For many of the

[6] Ofwat's general duties with respect to the water sector and its general environmental and recreational duties are set out in sections 2 and 3 WIA91 respectively.

PCLs we use comparative assessment to reach a view of a stretching but achievable level of performance, which we can use to hold companies to account. These PCLs are accompanied by Outcome Delivery Incentives (**ODIs**), such that customers' bills decrease if companies do not reach their PCL, and increase – to allow for the incentive payment – if companies deliver a higher level than the PCL.

- **Relative performance commitments**. In some areas of performance, such as customer service, we do not set a PCL, but measure companies' performance relative to each other to decide on the incentive or underperformance payments they receive. In PR24, for example, we have C-Mex, D-Mex and BR-Mex measures which consider relative service performance provided to household customers, developer customers and business retail customers.

- **Assessing and ranking business plans**. During price reviews, we ask companies to produce stretching business plans which deliver more for customers and the environment. Those companies which demonstrate quality and ambition are rewarded and allow us to better calibrate our price review packages for the sector.

- **Monitoring**. We use comparisons in our ongoing monitoring and regulation of the market, intervening in other ways that may be more appropriate, short of enforcement, if we see companies slipping behind. For example, in 2020 we compared the incumbent water companies' support for effective markets, including developer services markets and business retail markets.[7] We found that some companies supported markets much better than others. We sent letters to each company identifying the areas where they had performed well and the areas that needed attention.

- **Enforcement**. We also make use of comparisons in our enforcement activities, for example, after our review of performance during the Freeze Thaw[8] incident in 2018.[9] This comparative review found that while some companies had been well prepared for the extreme weather event, others had performed badly, causing substantial hardship for their customers. Four companies were required to submit detailed, externally audited, action plans setting out how they would address the issues we identified.

[7] See Ofwat, August 2020, 'Review of incumbent company support for effective markets'.
[8] The thaw that followed the 'Beast from the East' in late February and early March 2018 left over 200,000 customers in England and Wales without water for over 4 hours; and over 60,000 customers without supply for over 12 hours. Households, businesses, schools and public organisations across the country were affected by either low pressure or no running water, some for several days.
[9] See Ofwat, June 2018 'Out in the cold: Water companies' response to the 'Beast from the East''.

2.4 To protect our ability to make comparisons, the WIA91 provides for a special regime for water mergers[10] under which the CMA has a duty to refer completed and/or anticipated water mergers for an in-depth phase 2 investigation unless it finds that: (a) for anticipated mergers, the arrangements are not sufficiently far advanced or not sufficiently likely to proceed to justify a reference; (b) the water merger has not prejudiced, or is not likely to prejudice, Ofwat's ability in carrying out its functions to use comparative regulation; or (c) the water merger has prejudiced, or is likely to prejudice, Ofwat's ability to regulate, but the prejudice in question is outweighed by RCBs.[11]

2.5 Section 33B WIA91 requires us to provide the CMA with an opinion with respect to issues under (b) and (c).[12] Our Statement of Methods sets out how we assess mergers.[13]

[10] The special water merger regime was introduced by Water Act 2014.
[11] See Sections 32, 33 and 33A WIA91.
[12] See Section 33D(6) and (7) WIA91.
[13] See Ofwat, October 2015, 'Ofwat's approach to mergers and statement of methods'.

3. Ensuring accurate and efficient cost allowances

3.1 Cost assessment is a key element of price reviews. It is the process of setting a total expenditure (totex) allowance for each company for a period of five years.

3.2 Cost allowances need to be set at an efficient level – customers should not pay extra for an essential good where they have no choice of supplier. At the same time, cost allowances should not be set too low, so that companies can carry out their statutory activities and deliver high quality services to customers.

3.3 Cost assessment heavily relies on comparative analysis. A loss of a comparator through a merger can have a detrimental effect due to:

- A loss of precision of our benchmarking models, which in turn can lead to inaccurate cost allowances.

- A loss of an efficient company, which may be used to set an efficiency benchmark for the rest of the sector, now or in the future, and lead to lower prices for customers.

3.4 At PR19 and PR24 our view of the efficient totex allowance for water companies is built on three main building blocks, all of which heavily rely on benchmarking assessment:

- **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.

- **Wholesale enhancement costs** are costs to enhance the capacity or quality of service beyond a base level. There are various enhancement activities, such as investment in new metering, improving water quality and improving service resilience.

- **Residential retail costs** are incurred by water companies in delivering retail services, such as customer service costs, billing and meter reading to residential customers. Residential retail costs also include bad debt and bad debt management costs.

3.5 In this section we assess the impact of the merger on:

- the precision of our base cost allowances;
- our base cost efficiency benchmarks;
- our enhancement cost assessment; and
- our residential retail cost assessment.

The precision of our base cost allowances

3.6 To develop our base cost allowances we use econometric modelling. We measure the precision of an econometric model through the confidence interval around its predicted values. The narrower the confidence interval the more precise is the model.

3.7 Two key factors affect the size of confidence intervals (for a given level of statistical significance): sample size and data variation.

3.8 Confidence intervals typically reduce (ie become narrower) as the sample size increases. But they can increase (ie become wider) if the additional data introduces substantial additional variation.

3.9 A merger reduces the number of comparators in the sector and therefore the sample size available to estimate our models. We would therefore expect that with each merger the confidence interval around our models' predictions would become increasingly larger. That is, the models become less precise. However, there may be exceptions – the confidence interval can become narrower when the removal of a company from the sample significantly reduces the data variation of the sample.

3.10 SES has been highly inefficient in recent years. It sits relatively high above our regression lines. Its removal from the sample and integration with SWB reduces variation within the sample. As seen in the analysis below, the interaction between this and the reduction of the sample size, leads to a mixed results with instances of models losing precision and instances of models gaining precision.

Pennon's view

3.11 Following the approach taken in the merger between SWB and Bristol Water in 2021 (**Bristol Merger**), Oxera has provided a precision assessment based on two approaches: the general approach and the specific approach.

3.12 The general approach does not account for the specific characteristics of the merging parties. It estimates the impact on the standard error of the models resulting from a reduction in degrees of freedom related to a loss of one company – any company - from an initial set of 17 companies. Oxera finds that the standard error will increase by [0-5]%. This is the same impact as was identified with respect to the Bristol Merger.

3.13 The specific approach measures the loss in models' precision related to the specific merging parties, based on current data, models and companies' efficiency performance. Oxera considers the impact of the merger on the confidence interval of the models' predicted costs. It uses Ofwat's PR24 consultation models[14] and shows that out of the 24 models included in the consultation, the average size of the confidence intervals across all predictions (ie across all years and companies) decreases in [REDACTED✂----] models and increases in [REDACTED✂----] models. In other words, it concludes that the merger leads to improved precision in [REDACTED✂----] models and lower precision in [REDACTED✂----] models.

3.14 Oxera also presents results from the specific approach where the analysis is done at the company level, rather than at sector level as above. It reports that, on average across all 24 models, the precision of predicted costs improves for [REDACTED✂----] out of 16 companies and deteriorates for the remaining [REDACTED✂----], and that changes in accuracy are 'unlikely to be material'.[15]

Our assessment

3.15 We consider that the general approach is useful as it illustrates the loss in models' precision we would generally expect given the number of comparators at our disposal. It provides a useful alternative view to the specific approach. The results of the general approach are less sensitive to the specific data and models being used, compared with the specific approach, and as such are more robust to changes over time.

3.16 This is particularly relevant as the SES Merger will not have an impact on our ability to use comparisons in cost assessment today, ie at PR24, but in the future, from PR29.[16] As such, any results using the PR24 models can only ever be illustrative.

3.17 With regard to the specific approach, we consider that the most relevant analysis of models' precision is at the company level, not at the sector level as presented in Table 14 of Pennon's MIA. As sector regulator we are concerned to get our cost assessment right for each company, not just 'on average' for the sector. Conclusions on models' precision at sector level, where reduced precision for some companies is being netted off with improved precision for others, disregards potential detrimental impacts on individual companies.

3.18 We replicated Oxera's precision analysis at a company level, which we present in Table 1 below. The table marks in red instances of deterioration in precision, and in green, instances of improvement in precision. It shows that there are many more incidents of

[14] This is a set of 24 wholesale water activities' models which Ofwat put forward in its April 2023 consultation. See Ofwat, April 2023, 'Econometric base cost models for PR24'.
[15] See the MIA, paragraph 4.67, page 48.
[16] This is because the determinations for PR24 are based on current and historical data, where the merger has not been in place.

deterioration in model precision when the analysis is done at the company level than at the sector level.

3.19 Specifically, the precision of [50-60]% of company/model predictions deteriorate. It is also important to note that [REDACTED✂----] companies - [REDACTED✂----] - will see a deterioration in precision in at least [70-80]% of the models.

3.20 Many of the models whose accuracy improve are whole models that use the 'booster pumping stations' variable (as opposed to models that use an alternative measure—the 'average pumping head'—where there are some material deteriorations in precision). This may be because SES has the lowest value of this variable in the sector, and the removal of an 'extreme' value has the effect of reducing the variability of models' predictions.

Table 1: SES Merger impact on the size of the confidence interval around models' predictions (relative increase in confidence intervals)

Model #	Service	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
1	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
3	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
4	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
5	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
6	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
7	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
8	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
9	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
10	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
11	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
12	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
13	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
14	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
15	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
16	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
17	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
18	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
19	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
20	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
21	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
22	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
23	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
24	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
All models avg.		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Models with poorer precision		18/24	11/24	20/24	15/24	10/24	19/24	10/24	18/24	18/24	17/24	13/24	10/24	8/24	8/24	9/24

Notes:

(i) Light green/red represents improvements/deteriorations in accuracy of less than 10%. Dark green/red represents improvements/deteriorations in accuracy of more than 10%.

Model #	Service	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

(ii) Percentages are calculated as [($CI/\hat{Y}$ pre-merger) – ($CI/\hat{Y}$ post-merger)]/($CI/\hat{Y}$ pre-merger), where CI is the 90% confidence interval and $\hat{Y}$ is model's predicted costs.

(iii) WRP = water resource plus models (ie models that include the cost of water resources, raw water distribution and water treatment); TWD = treated water distribution models, and WW = wholesale water models.

3.21 Table 1 presents the relative impact on precision – that is, the percentage change in the size of the confidence interval for each company due to the merger – similar to the way it is presented in Pennon's MIA Table 14. The comparison shows that an assessment at the company level not only results in more instances of deterioration in model precision, but also in higher materiality of deterioration. Whereas in the MIA any deterioration in precision, based on the sector level assessment, does not exceed [5-10]%, our analysis shows multiple instances of deterioration that exceed this level. We marked in dark red instances where the merger leads to an increase of over 10% in the prediction's confidence interval. [REDACTED✂----] companies will see a material deterioration in at least one of their models' predictions.[17]

3.22 Perhaps a more intuitive way to look at the results is in terms of absolute increases/ decreases in the confidence intervals of predictions due to the merger. This is presented in Table 2 below.

Table 2: SES Merger impact on the size of the confidence interval around models' predictions (absolute increase in confidence intervals)

Model #	Service	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
1	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
3	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
4	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
5	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
6	WRP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
7	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
8	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
9	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
10	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
11	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
12	TWD	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
13	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
14	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
15	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
16	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
17	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
18	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
19	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

[17] We recognise that our practice of triangulating models' results in a price control is likely to mitigate reductions (or improvements) in precision in individual models.

Model #	Service	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
20	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
21	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
22	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
23	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
24	WW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
All models avg.		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Poorer precision		18/24	11/24	20/24	15/24	10/24	19/24	10/24	18/24	18/24	17/24	13/24	10/24	8/24	8/24	9/24

Notes:

(i) Light green/red represents improvements/deteriorations in accuracy of less than 2%. Dark green/red represents improvements/deteriorations in accuracy of more than 2%.

(ii) Percentages are calculated as ($CI/\hat{Y}$ pre-merger) – ($CI/\hat{Y}$ post-merger), where CI is the 90% confidence interval and $\hat{Y}$ is model's predicted costs.

(iii) WRP = water resource plus models (ie models that include the cost of water resources, raw water distribution and water treatment); TWD = treated water distribution models, and WW = wholesale water models.

3.23 Again, we mark in red instances where the absolute percentage increase in confidence interval is above 2% (that is, 1% on each side of the prediction). [REDACTED✂----] of the 15 companies examined experience an absolute increase in confidence interval of 2% or more (reaching to over [REDACTED✂----] for [REDACTED✂----]). For example, in a number of wholesale water models, the confidence interval of [REDACTED✂----] cost prediction increases from [REDACTED✂----] to [REDACTED✂----].

3.24 We acknowledge that the models' confidence intervals are relatively wide to begin with. This is largely due to the already small number of comparators that we have in the sector before the merger. Recognising this, we complement our benchmarking models with a detailed process of considering companies' representations (eg 'cost adjustment claims') and undertake additional analysis outside of the models in price reviews. A widening of models' predictions confidence interval by over 2% is material. It can have material implications on companies' cost predictions, and it can significantly increase the volume of analysis needed to complement our benchmarking models' results. We do not accept Oxera's claim that the reduced precision is 'unlikely to be material'.[18]

3.25 Considering the evidence above, we consider that the merger has detrimental effects on the precision of our models and may prejudice our ability to set accurate base cost allowances for individual companies.

Impact on our cost efficiency benchmarks

3.26 In a price review we compare expenditure data across all the water companies to identify those that are relatively efficient. We use these relatively efficient companies to

[18] See the MIA, paragraph 4.67.

set an efficiency benchmark for the rest of the sector. We set cost allowances that require the rest of the sector to 'catch up' with the efficiency benchmark.

3.27 The loss of a comparator through a merger can have a detrimental effect on the efficiency benchmark. If we lose an efficient company through a merger, the efficiency benchmark may become less stringent. This will lead to higher prices for customers.

3.28 We use 'static analysis' to assess the impact of a merger on the efficiency benchmark today (e.g. given current efficiency positions, data and models).

3.29 Even if the loss of a comparator does not lead to an immediate detrimental impact on the benchmark, it may lead to a detriment in the future, as companies change their relative efficiency position in the sector, for example due to successful integration of innovation and best practice.

3.30 We use a 'forward-looking' analysis to assess the potential impact of a merger on the efficiency benchmark in the future.

Pennon's view

3.31 Oxera provides a static and forward-looking assessment of the merger impact on the efficiency benchmark.

3.32 In the static approach it estimates a merger benefit in [REDACTED✂----] of 44 scenarios it has considered. The monetary impact on customers ranges from a detriment of £[REDACTED✂----] to a benefit of £[REDACTED✂----] over five years.[19]

3.33 In the forward-looking approach it estimates a benefit in [REDACTED✂----] scenarios considered. The benefit ranges from £[REDACTED✂----] to £[REDACTED✂----] over five years.

3.34 Oxera concludes that 'in terms of the impact on the cost benchmark, in the majority of cases the merger does not result in detriment to Ofwat's ability to make comparisons between water enterprises'.[20]

Our assessment

3.35 To set an efficiency benchmark, it is the evidence provided by the high performing companies in the sector on cost efficiency that is most important.

[19] These results cover Oxera's core and sensitivity analyses.
[20] See the MIA, paragraphs 4.27.

3.36 In accordance with our Statement of Methods, in our assessment of the impact of this merger we have assumed that the merged company's total cost is the sum of costs of the two merging entities, without assuming any merger efficiencies.[21] As such, the merged entity does not provide new information on cost efficiency to enhance the efficiency evidence we already have. In other words, a merger provides no new information on cost efficiency that would allow us to set a more stretching benchmark.

3.37 An efficiency benchmark that is based on the efficiency of leading companies can either become less stringent or be unaffected by a merger. It will become less stringent where at least one of the entities is an efficient company that sets the benchmark for the rest. It will be unaffected if both entities are inefficient and do not set the benchmark for the sector.

3.38 SWB was assessed to be an efficient company in recent price controls. SES was assessed to be inefficient. Losing SWB as an independent comparator and replacing it with a merged company, where its efficiency is averaged with SES' inefficiency, is overall harmful as it inevitably results in a lower level of efficiency amongst the sector's most efficient companies, which we use to determine our benchmark.

3.39 Any assessment that suggests that the merger leads to a benefit due to a more stretching efficiency benchmark, must therefore be interpreted with caution.

3.40 We consider that the instances in which Pennon's assessment shows a merger benefit are not driven by a genuine improvement in observed efficiencies amongst leading companies, but by the way it calculates the benchmark.

3.41 Oxera uses the 'upper quartile' as the efficiency benchmark, ie a company that is more efficient than 75% of companies in the sector but less efficient than the top 25% of companies. With an initial set of 17 comparators, the upper quartile is exactly the fifth most efficient company. When the number of comparators reduces from 17 to 16, as in this merger, the upper quartile benchmark moves to between the fourth and fifth most efficient companies. That is, the benchmark now puts weight on the efficiency of the fourth company and therefore becomes more stringent.

3.42 There is a 'formula effect' here – the benchmark is affected by the way it is calculated (ie by its underlying formula) even when there is no new information on high level efficiency in the sector. It is this formula effect that is driving the 'benefit' results in Oxera's analysis.

[21] See our Statement of Methods page 63: "At Phase 1, we will consider the effect of the merger compared with the counterfactual that creates the most detriment, that is, the counterfactual against which the merger would do most harm to our ability to make comparisons as long as we consider that scenario to be a realistic prospect."

3.43 The upper quartile could become less stringent only if the efficiency level of the fourth and/or fifth companies sufficiently reduce due to the merger to offset the formula effect. In the SES Merger, Oxera shows that prior to the merger SWB is ranked third and, following the merger, the merged company retains the same rank with a slightly lower efficiency score. As no reduction in the efficiency of the fourth and fifth companies is shown in Oxera's analysis, we consider that the formula effect discussed above is driving the results.

3.44 Our approach to price controls and setting the efficiency benchmark is not fixed and it may evolve over time based on what we consider to be the most appropriate way to regulate the sector. If instead of relying on the upper quartile we were to use only information from the most efficient companies in the sector to set the efficiency benchmark, then the merger would not result in a benefit – it would be either neutral or detrimental. This is because the merger does not result in new information on greater efficiency for the most efficient companies in the sector.

3.45 For example, if we were to set the efficiency benchmark based on the fourth company, as we did at PR19, the merger would be neutral to the efficiency benchmark. If we were to set an efficiency benchmark based on the third company, it would be detrimental. Likewise, if we were to take a different approach in future, for example by setting an efficiency benchmark based on the average efficiency of the sector's leading companies (eg based on the top half of companies), the merger would be detrimental again. In all these cases, which are not included in Oxera's scenarios, the merger would lead to a detriment and higher prices for customers across the sector.

3.46 The results in the MIA are based on applying the upper quartile efficiency benchmark mechanistically. As above, setting an efficiency benchmark in a price control is not a mechanistic process. We have used the median, the upper quartile, or a specific company's efficiency level (eg the fourth company at PR19) to set the benchmark in the past. The decision is informed by various factors, including the confidence we have in the benchmark and whether it provides a reasonable challenge. We do not know what approach we will be using to set the benchmark at PR29 and beyond. As such we put less weight on results showing a benefit which are obtained by a mechanistic application of the upper quartile, when the merger reveals no new information on high efficiency in the sector.

3.47 Oxera notes that the benefit it identifies in the SES Merger 'can be compared with the Pennon/BRL merger where a detriment of £[REDACTED✂----] was estimated under the same approach'[22]. The reason for the difference in results between the two mergers is that in the Bristol Merger, SWB was assessed—with PR19 data and models—to be fourth efficient in the sector, not third as in this merger assessment, which relies on

[22] See the MIA, para 4.20.

different data and the models for PR24. As such, the Bristol Merger caused a deterioration in the efficiency of the fourth company (due to 'losing' SWB as an independent comparator) with a direct detrimental effect on the benchmark, which worked to offset the formula effect in some scenarios. In our view, this comparison between the two mergers instead highlights the sensitivity of a merger's impact assessment to the models and data used.

3.48 We acknowledge, however, that the dilution of SWB's efficiency is relatively modest with this merger, as the size of SES is small relative to SWB so it has little impact on the merged companies' efficiency. This means that we do not expect a large detrimental impact on the benchmark, at least in the short term.

3.49 Oxera's forward-looking assessment consistently finds merger benefits. Oxera's results are driven by two key factors: (i) the use of the upper-quartile (or upper-quintile) as the efficiency benchmark, and (ii) the assumption that SWB is the third most efficient company in the sector as a starting point. Under these assumptions, the assessment is likely to reflect mainly the 'formula effect'; namely, that the move from 17 to 16 comparators moves the upper-quartile closer towards the efficiency of the fourth company (hence becoming more stringent), with little or no impact from the loss of SWB as an independent efficient comparator. This is a similar concern as with the static assessment.

3.50 As another source of forward-looking assessment, Oxera provides results based on different scenarios, or sensitivities, to the static approach. Oxera provides scenarios that vary the benchmark period. While most scenarios show that the merger leads to a more stringent efficiency benchmark, some scenarios lead to a less stringent efficiency benchmark, and have a larger (detrimental) impact on the benchmark – and overall cost to customers – than scenarios that show a benefit.[23]

3.51 We acknowledge the importance of the forward-looking effect. Companies' efficiency positions change over time, as well as our data, models and approach. We also recognise that it is difficult to develop a robust forward-looking assessment as it involves probabilistic estimations of the extent to which a company's cost efficiency level (or indeed performance level under the outcomes framework) might change over time and various other assumptions.

3.52 In the SES Merger, we consider that our key concerns relate to the precision of our benchmarks rather than to the level of the efficiency benchmark. This is consistent with evidence from the precision analysis and static analysis discussed above. Given SES' long standing poor performance on cost efficiency, we do not think efficiency benchmark concerns will become significantly greater on a forward-looking basis. We

[23] See the MIA, Annex 3, Table 3.2, page 16.

therefore consider that evidence from a forward-looking analysis, although otherwise important, does not change our view of the impact of the SES Merger and we do not consider that it should be given greater weight than the static analysis in this case.

In summary, we consider that the SES 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. We consider that the merger cannot lead to genuine benefits in this respect. We acknowledge, however, that the risk of a material detriment to our cost efficiency benchmark is not high given that SES is small relative to SWB.

Impact on comparative assessment of enhancement costs

3.53 Where possible, we use comparative assessment to assess and challenge enhancement investment proposals. At PR19 we used benchmarking models in the areas of meeting lead standards in water, investment in new meter installations, and investment to balance water supply and demand. We used benchmarking in other enhancement areas as well but to a more limited extent.

3.54 In our final methodology for PR24 we stated that 'We intend to make greater use of benchmarking in our assessment of enhancement expenditure at PR24'.[24]

3.55 Due to the irregular and lumpy nature of enhancement expenditure, [REDACTED✂----]. Further, due to evolving technologies, quality and environmental standards, which affect enhancement expenditure, new models need to be developed regularly to reflect the evolving cost drivers of enhancement investment. For example, at PR24 most companies are planning to install smart meters, which means that the PR19 models, which benchmarked costs of installing conventional meters, may not be fit for purpose in the assessment of this merger.

3.56 This means that the models and data in enhancement are more specific to the period in which they are used. Any quantitative analysis and an attempt to monetise costs and benefits based on historical data and models would have limited value for the purpose of assessing this merger.

3.57 However, this cannot be taken to mean that there is necessarily less concern regarding the detrimental impact of the merger on enhancement expenditure compared with base costs for various reasons. First, due to the irregular nature of costs it is more difficult to develop robust enhancement models compared with the base models. We therefore need as many comparators as possible. Also, due to the lumpy nature of

[24] Creating tomorrow, together: Our final methodology for PR24. Appendix 9 Setting expenditure allowances, Ofwat, December 22, page 5.

investment we generally develop cross-section models, where the data is averaged over time, rather than panel data models as in base costs. This means that we have fewer data points for our enhancement models compared to base models, so that losing a comparator is likely to have a larger impact. Finally, in enhancement we often make comparisons based on a sub-sample of companies, as not all companies necessarily incur expenditure in all areas of enhancement. This again means that the value of a comparator is potentially greater than for base costs, where all companies incur the costs every year.

3.58 In the decision on the Bristol Merger the CMA found that the merger may have a detrimental impact on all three benchmarking models it examined.[25]

3.59 Our view is that the merger is likely to prejudice our ability to make comparisons when assessing enhancement expenditure in PR29 onwards.

Impact on our residential retail cost assessment

3.60 Residential retail costs represent about 10% of water companies' total costs. They include mainly customer-facing activities such as billing, customer service, meter reading, bad debt and bad debt management.

3.61 Retail expenditure is assessed entirely through benchmarking analysis. We have used three types of econometric models at PR19, and have indicated that we will continue using the same at PR24:

- Models for bad debt and bad debt management costs.
- Models for the costs of other retail activities (i.e. not related to bad debt).
- Models for total retail costs.

3.62 The models estimate the relationship between retail costs and company characteristics such as the number of customers, the number of metered customers, average bill size and various measures of local deprivation. The latter two characteristics are cost drivers of bad debt.

Pennon's view

3.63 Pennon does not provide a merger impact assessment on residential retail cost assessment. It explains that retail costs account for a small part of a water companies' total costs and expenditure on certain activities, such as customer services, and may be comparable with expenditure on similar activities in other sectors. The remaining costs

[25] See, CMA, February 2022, 'Completed acquisition by Pennon Group plc of Bristol Water Holdings UK Limited', paragraph 125.

– primarily bad debt costs – are quite immaterial and any merger impact assessment is likely to be far less material that the impact on wholesale base costs.[26]

3.64 The MIA recognises that some of SES's characteristics may be of use for our cost benchmarking[27] and proposes to continue providing separate information on retail costs and costs drivers to Ofwat should the merger be approved.

Our assessment

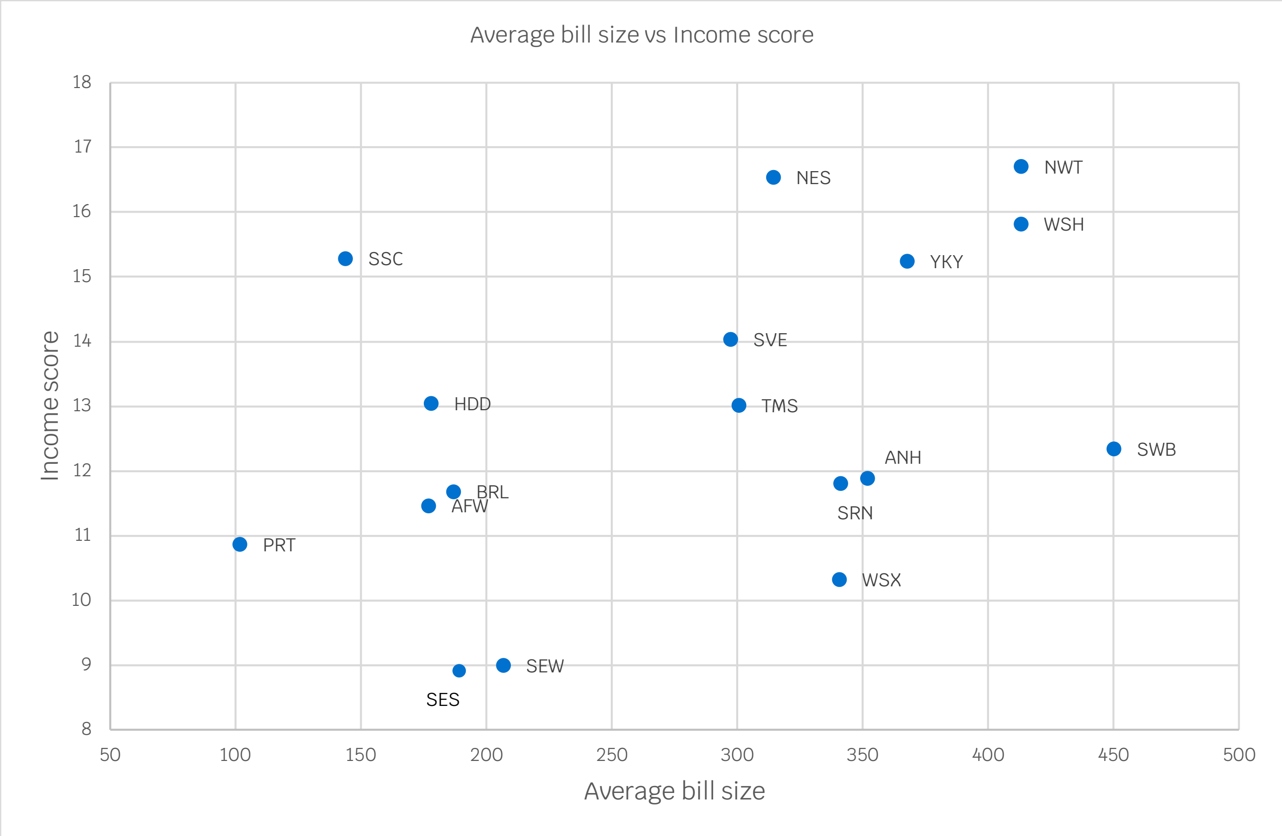
3.65 We accept Pennon's arguments for putting less weight on the merger's impact on the assessment of retail costs. However, although we agree that for some retail activities, such as customer service, we may be able to draw on benchmarks from outside the sector, in practice doing so can create difficulties due to comparability issues, and the use of such external benchmarks to date has been very limited.

3.66 Our key concern in residential retail is in relation to bad debt. Bad debt costs represent a sizeable portion of total retail costs (c. 30-40%) and, due to factors unique to the water sector,[28] levels of bad debt are less comparable to levels in other sectors.

3.67 Our bad debt models estimate a relationship between average bill size, local deprivation and bad debt costs. Figure 1 below shows SES' characteristics of low average bill and low income-score (a measure of deprivation) are relatively scarce in our sample, and likely to be important for the precision and robustness of our bad debt models, in particular for companies with similar characteristics.

Figure 1: Comparison of companies' bad debt cost drivers – Income scores and average bill sizes

[26] See the MIA, paragraph 4.5.
[27] Ibid, paragraph 1.18.
[28] In particular, that water companies are not allowed by law to restrict or disconnect domestic customers for non-payment of water bills.



3.68 Our view is, therefore, that the merger is likely to prejudice our ability to set residential retail costs through comparisons. This is because SES has characteristics which are important to our econometric modelling of bad debt levels and the merger would lead to the removal of the SES data points.

4. Delivering outcomes to customers

4.1 Outcomes refer to aspects of companies' service performance that are important for customers and the environment. They include performance on leakage, supply interruptions, water quality and more. Without regulation, profit maximising monopolies would have an incentive to deliver sub-optimal outcomes. Protecting the interest of customers and the environment by ensuring water companies deliver high quality outcomes is therefore a key objective of our regulation.

4.2 We do that using the 'outcomes framework'. In a price control we set PCLs for companies for various outcomes. We use ODIs to incentivise companies to reach and exceed these PCLs. ODIs are monetary penalties and rewards that apply for performance below and above the PCL respectively.

4.3 Comparative assessment of performance across companies is key to our ability to set stretching but achievable PCLs to protect the interest of customers. To set PCLs, we compare performance levels across companies, identify high performance and best practices, and set these as a benchmark for the rest of the sector. The more comparators we have the more credible our benchmarks are, and the faster the pace of change should be over time.

4.4 Common performance commitments apply to all companies in England and Wales. They include metrics in relation to customer service (e.g. water supply interruption, water quality, quality of service), environmental outcomes (e.g. leakage, per-capita consumption) and asset health (e.g. mains repairs, unplanned outage). Bespoke performance commitments, on the other hand, apply to individual companies rather than the entire sector.

4.5 SES is a strong performer in relation to all common performance commitments, except per capita consumption. As such, it is a useful comparator, which has helped us hold companies' performance to account.

Pennon's view

4.6 Oxera, on behalf of Pennon, has carried out a static assessment of the merger at four different time periods. For each common performance commitment, it assesses the change in the upper quartile (or median) performance resulting from the merger. It then quantifies the financial impact of the merger on customers across the sector by using the PR19 ODIs.[29] The results are presented in Table 3.

4.7 Oxera also demonstrates the overall impact of the merger by referring to the aggregate net impact across all performance commitments.

Table 3: Impact of the merger on performance commitment levels – Oxera's assessment (£m of 2022-23 over five years)

Performance commitment	2019/2020	2021/2022	2022/2023	2029/2030
Water Supply Interruptions (UQ)	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment	£[REDACTED✂----] benefit
Leakage (UQ)	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment	£[REDACTED✂----] benefit	£[REDACTED✂----] detriment
Per Capita Consumption (UQ)	£[REDACTED✂----] benefit	£[REDACTED✂----] benefit	£[REDACTED✂----] benefit	£[REDACTED✂----] benefit
Water Quality Contacts (UQ)	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment	£[REDACTED✂----] detriment
Unplanned Outage (UQ and median)	£[REDACTED✂----] detriment (Median)	£[REDACTED✂----] (UQ) or £[REDACTED✂----] (Median) detriment	£[REDACTED✂----] benefit (UQ) or £[REDACTED✂----] detriment (median)	£[REDACTED✂----] (UQ) or £[REDACTED✂----] (Median) detriment
Mains Repairs (median)	£[REDACTED✂----] benefit	£[REDACTED✂----] benefit	£[REDACTED✂----] detriment	£[REDACTED✂----] benefit

4.8 Oxera acknowledges that its assessment is a simplification of the actual process Ofwat undertakes to determine PCLs at price reviews, as it assumes that PCLs are determined mechanistically at the upper quartile or median sector performance for all common performance commitments.

4.9 Oxera states that while various periods are considered, they focus on the latest outturn data (i.e. up to 2022/23) and on companies' projected performance by the next price review, PR29 (i.e. up to 2029/30). Oxera also considers PR19, as a historical point of reference, but notes that 2019/20 results are unlikely to be representative of future industry performance due to convergence in industry performance on unplanned outages, the main driver of aggregate detriment for that period.

[29] This will understate the extent of any detriment or benefit to customers as ODI rates are set lower than customers' willingness to pay, to recognise that customers already pay for improvements (or are rebated for shortfalls) in performance (assuming these improvements require additional expenditure) through Ofwat's totex cost sharing arrangements.

4.10 Oxera argues that despite SES being an industry leader on several performance commitments, it is unlikely that the merger would result in a significant detriment to Ofwat's comparative regime. This is because:

- At PR19 only the water supply interruptions (WSI) performance commitment was set based on a relatively mechanistic comparative assessment.
- Based on recent performance SWB is catching up with SES.
- Based on companies' business plan forecasts of performance commitments, performance is expected to converge and therefore the impact of losing SES as a high performer reduces over time.
- The estimated detriment in the static approach is generally not material.

Our assessment

4.11 Although Oxera's assessment is a simplification of the actual process of determining PCLs in a price review, we agree that it is fit for the purpose of illustrating the scope of benefits and detriments of the merger.

4.12 The results in Table 2 are largely as expected. Where SES is a high performer the merger results in a detriment, and where SES is not a high performer, such as in per-capita consumption, it shows a benefit.

4.13 We consider that the results above show detriments from the merger, which are likely to prejudice our ability to set stretching and appropriate PCLs using comparisons in the sector.

4.14 We make three further comments on Oxera's assessment and findings.

4.15 First, as we argued in relation to the impact of a merger on efficiency benchmarks above, it is important to recognise that a merger cannot be beneficial for the setting of PCLs in the sector. A merger leads to the replacement of two independent comparators with a single comparator that is an average of the two. Observations on top performance in the sector—which we use for setting PCLs—will therefore necessarily be reduced or unaffected (the latter will be the case in a merger of two poor performing companies). A merger can therefore be either detrimental or neutral to the availability of information on high performance in the sector.

4.16 The mixed results above, of detriments and benefits, are merely a product of the way the upper quartile (or median), which Oxera uses to set the PCLs for the sector, is calculated. To illustrate, the upper quartile performance in the sector will become more stretching even if the only change being made is the removal of a poor performing company.

4.17 Second, Oxera argues that results from PR19 (up to 2019/20) are less representative due to a trend of convergence in unplanned outages. It therefore focuses on results from the most recent period (up to 2022/23) and those of the forecast period (up to 2029/30).

4.18 We accept that there has been a convergence in unplanned outage performance in recent years and it can be argued – to the extent we have confidence that this convergence will continue – that the historical period is not representative of the future. However, there has not been a clear (or any) convergence on other outcomes. Therefore, due weight should be placed on historical results. We also do not consider that it is appropriate to put more weight on results obtained from forecasts of performance, whose convergence may reflect business plan ambitions, over results based on actual performance.

4.19 Third, we do not consider that it is appropriate to aggregate the monetary estimates of benefits and detriments across all outcomes to assess the net impact of the merger on comparative performance commitments across the sector.[30] Ofwat is not looking to improve the performance of the sector on a 'net' basis, across all outcomes, but rather to push companies to improve their performance on each and every outcome. Each outcome is important for customers on its own merit. Aggregating the outcomes may hide important detriments arising from the merger. Benefits in other outcomes do not offset them.[31]

4.20 The aggregation is not appropriate also because for some outcomes, Oxera's mechanistic approach of setting PCLs is not consistent with the actual process that takes place in a price review (where we take into account various factors, such as a company's historical performance and any relevant company specific circumstances beyond management control). This is the case, for example, for mains repairs where we have not set a uniform benchmark for all companies, but rather a company specific PCL primarily based on a company's historical performance. Oxera's impact assessment using a uniform benchmark for mains repairs is therefore likely to find relatively large detriments or benefits, which are not too insightful, and should not be aggregated with the estimated impact of other outcomes, where our price review approach is closer to Oxera's assumptions, such as in water supply interruptions.

[30] See the MIA at paragraph 4.43.

[31] What is more, as we argue in the outset, there are no real benefits as a result of the merger on our ability to set stretching performance benchmarks. It is merely down to the way the upper quartile benchmark is calculated.

5. Relevant customer benefits of the merger

5.1 Section 33B(1)(b) WIA91 states that Ofwat's opinion to the CMA should consider whether any prejudice to our ability to make comparisons is outweighed by RCBs resulting from the merger.

5.2 RCBs are limited to benefits to relevant customers in the form of lower prices, higher quality, greater choice of goods or services, or greater innovation in relation to such goods or services.[32] Relevant customers are current and future customers of the merging enterprises at any point in the chain of production and distribution and are therefore not limited to final consumers.[33]

5.3 Only benefits which are unlikely to accrue without the merger are merger specific and can amount to RCBs.[34]

5.4 In our assessment of RCBs we take into account the criteria set out in our Statement of Methods:[35]

- Are there RCBs?
- How likely or certain are the benefits to be achieved?
- Are the benefits merger specific?[36]
- Are the benefits expected to accrue within a reasonable time period of the merger?
- Are the benefits likely to be sustained?

5.5 In this section, we summarise Pennon's views on RCBs resulting from the merger and our assessment of these RCBs. Pennon identified the following RCBs in its MIA, which we discuss further below:

- delivering lower bills for customers through the waiver of the small company premium (SCP) and synergies;
- enhancing the voice of the customer;
- service improvements;
- environmental benefits;

[32] See Schedule 4ZA, paragraph 7(1)(a) WIA91. For the purpose of Sections 33A, 33B and 33D WIA91, 'relevant customer benefit' has the meaning given by paragraph 7 of Schedule 4ZA WIA91.
[33] See Schedule 4ZA, paragraph7(4).
[34] See Ofwat, October 2015, 'Ofwat's approach to mergers and statement of methods', page 69.
[35] See Ofwat, October 2015, Ofwat's approach to mergers and statement of methods, section A1.4.
[36] Benefits are typically not merger specific if they could accrue without the merger, for example, firms could obtain efficiencies without a merger by investing in innovation (eg by investing in staff or R&D capability), entering into a licensing agreement or using a buying group. For more detail see, Ofwat, October 2015, Ofwat's approach to mergers and statement of methods, A4.1 and CMA, Merger Assessment Guidelines, paragraphs 8.16 to 8.19.

- improved financial resilience; and
- maintaining a local presence.

5.6 We recognise that some benefits put forward by Pennon may qualify as potential RCBs, however we are not clear that they are certain and/or we believe that their value is not as high as the estimates provided in the MIA. Overall, we consider that such benefits as could constitute RCBs would in any event not outweigh the prejudice to our ability to make comparisons that arises as a result of this merger.

5.7 Table 3 provides a summary of our views on the RCBs put forward by Pennon. We provide more details further below. Pennon has also identified additional sector-wide benefits, which we comment on further below.

Table 3: A summary of Pennon's and our views on RCBs

Pennon's view	Our assessment
Delivering lower bills to customers: Pennon will waive the small company premium (**SCP**) request by SES for PR24. This will save each customer [REDACTED✂----] to [REDACTED✂----] per year over AMP8.	We accept this may be an RCB, but it is uncertain whether SCP will be awarded at PR24. We consider that the value of benefit per household is likely to be lower than suggested in the MIA.
Delivering lower bills to customers: The merger leads to synergy savings estimated to reach £10.5m per year. Circa [50-60]% of savings will be passed on to customers through WaterShare+.	We accept that some synergy savings are in principle merger specific (eg consolidation of boards), but most can be achieved without a merger. There is insufficient evidence in the MIA to support the level of saving estimates submitted by Pennon, but we recognise Pennon's commitment to pass through [50-60]% of the estimated savings, irrespective of whether they are realised. To this extent, efficiency savings committed to be passed through to customers may be considered RCBs.
Extending the WaterShare+ scheme to SES customers would enhance the customer voice.	We accept that WaterShare+ may have benefits such as the early sharing of cost outperformance with customers, which can qualify as RCBs, although they are not quantified. However, there is insufficient evidence that the merger would enhance SES customers' voice through the WaterShare+ scheme relative to current situation with an independent SES and customer panel.
Service improvements: The merger is an opportunity to bring the 'best of the best' to customers in each region by drawing on and sharing strengths (eg Pennon will expand its ambitious affordability support to include SES customers, with a pledge to eliminate water poverty by 2025 (SES aims for 2050)).	Not merger specific. Companies can improve their performance absent a merger. There is insufficient evidence that the Bristol Merger has led to improvements in outcomes.
The merger will lead to environmental benefits.	Not merger specific. Companies can improve their

Pennon's view	Our assessment
	performance absent a merger. There is insufficient evidence that environmental benefits will materialise.
Improved SES financial resilience from £[REDACTED✂----] equity injection.	Not merger specific. Finance can be obtained through means other than mergers. Valuing benefits at £[REDACTED✂----] is inappropriate and does not accurately reflect customer benefit.
Maintaining local presence of SES.	This is clearly not an RCB.

Delivering lower bills for customers

Pennon's view

5.8 Pennon claims that the merger would deliver lower customer bills due to: (i) the removal of SES's request for a SCP, and (ii) cost savings due to synergies created by the merger.

SCP waiver[37]

5.9 Pennon submits that it would remove the SCP request currently included in the SES' PR24 business plan. It estimates that this would translate to a saving of between [REDACTED✂----] and [REDACTED✂----] per household per year over AMP8. Pennon explains that Ofwat has proposed a 30bps uplift in the cost of embedded debt for smaller water only companies as part of its PR24 Final Methodology, while SES' business plan included an estimate that its cost of embedded debt for AMP8 would require an uplift of about 150 bps, as well as 26bps for new debt and 10bps for cost of carry. As Ofwat's final methodology assumes a 17% share of new debt (therefore 83% of embedded debt), Pennon explained this equated to a proposed weighted aggregate uplift of 139bps on the cost of debt relative to the Ofwat's 'notional company'.

5.10 Pennon's savings calculations are based on three types of average customer bill and three alternative costs of debt put forward by SES: (i) SCP of 30bps referred to in Ofwat's final methodology, (ii) no SCP, and (iii) SCP of 139bps proposed by SES.

5.11 Pennon states that the benefit from the waiver of any SCP that may be granted by Ofwat is certain, would not materialise without the merger, would accrue within a reasonable time (i.e. by the end of AMP8) and is likely to be sustained.

[37] See the MIA, paragraphs 1.32, 5.16, 5.39 – 5.45 and page 78.

Synergy savings[38]

5.12 Pennon argues that it expects to achieve merger cost savings of £10.5 million per year by year four. The breakdown is provided in Table 4 below. Pennon explained that these savings figures were derived based on its experience of merger savings delivered for Bristol Water, pro-rated to reflect SES' smaller size. [REDACTED✂----].[39]

Table 4: Pennon's synergy forecasts[40]

Area of savings (£m)	Year 1	Year 2	Year 3	Year 4
Operational performance / transformation initiatives	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]
Operational and back office integration	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]
Board level governance efficiency	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]
Retail	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]
Additional costs	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]
Net merger benefits	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]	[REDACTED✂----]

Pennon says that it will share these benefits with customers upfront (i.e. irrespective of whether they are delivered in practice) through its WaterShare+ scheme (earlier than envisaged by the regulatory mechanism), ensuring that at least [50-60]% of the merger's synergy savings are returned to customers. It says that this and its track record in previous water mergers indicates that the delivery of these benefits is highly likely. It also claims that its ability to sustain efficiencies is evidenced by its ongoing 'efficient' status in Ofwat's price control econometric models, and the fact that its business plans have been twice fast tracked.

Our assessment

SCP waiver

5.13 In our final methodology for PR24 we said that an uplift of 30bps over the sector cost of embedded debt allowance may be appropriate for a small, notionally structured, water only company. To receive an uplift, we would require robust evidence that customers of

[38] See the MIA, paragraphs 1.28 – 1.32, 5.46 – 5.53, and page 78
[39] See Pennon, 23 February 2024, 'The merger of South West Water and Sutton & East Surrey Water: RFI Responses', paragraphs 3.18 – 3.21 and 5.50.
[40] See the MIA, Table 5.3.

the company requesting a SCP had given informed consent to funding this cost.[41] Companies applying for an uplift would need to put forward quantitative estimates of the level of uplift sought for each component.[42]

5.14 We are considering companies' SCP requests and have not yet decided whether to provide SES with an uplift. If SES is not awarded the uplift, then the SCP waiver cannot be seen as a benefit over AMP8 (we note that SES requested but did not receive an uplift at PR19). If SES is awarded an uplift, then we would consider the SCP removal to be a merger-specific benefit.

5.15 Regarding the quantification of the potential SCP waiver benefit, we consider it highly unlikely that SES would be granted an uplift of 139bps. This uplift is significantly higher than the 30bps uplift we have indicated in our final methodology and significantly higher than any uplift indicated at PR19.[43] Further, neither Pennon (in the MIA) nor SES (in its PR24 business plan) provide evidence of customer support for an uplift of such magnitude. We therefore consider that the high valuation of this potential RCB is not credible.

5.16 A 30bps uplift, while consistent with the early view in our final methodology, is contingent on passing the customer support test. SES' business plan indicates that the value of a 30bps SCP is £1.65 per household per year in AMP8,[44] which is consistent with our initial estimates of circa [REDACTED✂----] per household per year.

Synergy savings

5.17 We agree that mergers can lead to efficiencies through operational and back-office integration. However, while some of the efficiencies identified by Pennon may be merger specific, such as [REDACTED✂----], we consider that most of the savings identified could be obtained through other means such as outsourcing, collaboration or restructuring.

5.18 Our issue also lies in Pennon's quantification of the efficiency savings. Pennon explains that its quantification of the efficiency savings is based on savings it delivered in the Bristol Merger adjusted to account for the size of SES. We understand that Pennon is on track to deliver its estimated savings in the Bristol Merger, but we do not have sufficient evidence to verify the amount of the savings estimated for this merger. It is therefore unclear how likely it is that savings of this magnitude materialise and are sustained.

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[41] See Ofwat, December 2022, '[Creating tomorrow, together: our final methodology for PR24, Appendix 11: Allowed return on capital]', section 4.1
[42] Ibid, page 87.
[43] Ibid, Table 4.9, page 89.
[44] See SES, '[SES Water PR24 Business plan Chapter 8: Financing our plan]', paragraph 20.

5.19 We note that in its submission Pennon offers a commitment to pass through at least [50-60]% of savings, irrespective of whether they are realised.[45] In this scenario a proportion of the synergy benefits could be deemed RCBs.

Enhancing the voice of the customer

Pennon's view[46]

5.20 Pennon describes its WaterShare+ scheme as a unique initiative, which provides customers with a voice and potential financial benefits. The scheme allows it to share outperformance gains with its customers on an annual basis (rather than every five years per the regulatory cost sharing mechanism) and provides an option to receive a bill reduction or shares in Pennon. It involves the Customer Advisory Panel which consists of customer, business and social representatives and also serves as the Independent Challenge Group for the 2025-2030 SWB business plan.

5.21 Pennon argues that the WaterShare+ framework provides a strong voice for the customer, in circumstances where customers value a say and a stake in their local water company. Pennon noted that SES has [REDACTED✂----] levels of customer engagement than Pennon and, following the merger, a separate local SES customer panel will form part of the overall WaterShare+ Customer Advisory Panel.

5.22 Pennon considers that this benefit meets our assessment criteria, namely, this benefit:

- is likely to materialise within a reasonable timeframe as WaterShare+ is an existing scheme and Pennon has committed to extend it to SES customers as soon as the regulatory process is complete;
- is merger specific as Pennon is the only company in the sector to run a scheme of this kind; and
- would be sustained as Pennon is committed to further WaterShare+ issuances and customer empowerment.

Our assessment

5.23 We recognise that the WaterShare+ scheme is unique and could bring benefits to customers. Specifically, it enables Pennon to share cost savings with its customers earlier than under normal regulatory arrangements (ie annually rather than every five

[45] See the MIA, paragraph 1.31.
[46] See the MIA, paragraphs 5.54 to 5.56, page 79, page 111, and Appendix B.

years) and that customers have a choice to convert these costs savings to equity in Pennon.[47]

5.24 However, we are unconvinced that the WaterShare+ scheme enhances the voice of SES customers over and above the voice they have currently, with SES as a local independent company with an independent management team and Board focussed on SES customers.

5.25 We also note that some water companies already have in place customer panels to represent customers' voices. In particular, SES is operating an independent customer scrutiny panel with a role which appears similar to WaterShare+ in that respect:

> 'The panel has a key role to act as a champion for our customers and to make sure we understand what they expect from their water company. It also plays a role in monitoring our performance on delivering our current commitments and challenging our progress on improvement plans.'[48]

The MIA does not clearly explain how the WaterShare+ scheme would enhance SES customers' voice beyond the voice provided by the current panel.

5.26 We consider that some benefits associated with the WaterShare+ scheme are relevant customer benefits from this merger (eg early sharing of cost savings discussed above). However, we do not consider that enhancing the voice of SES customers through WaterShare+ is a benefit specific to this merger.

Service improvements

Pennon's view[49]

5.27 Pennon argues that the performance strengths and weaknesses of each of SWB, Bristol Water and SES are complementary. Since there is a strength for almost every performance metric in at least one region, Pennon believes there is an opportunity to bring the 'best of the best' to customers in each region by drawing on and sharing these strengths over time.

5.28 Pennon submitted that it has a strong track record of integrating newly acquired businesses and using these to drive performance improvements across its corporate group. For example, Pennon says that SWB is a sector leader on affordability support

[47] We note that the WaterShare+ scheme and the regulatory cost sharing mechanism are equal on a net present value.
[48] See SES, 'SES Water Customer Scrutiny Panel | SES Water'.
[49] See the MIA, paragraphs 1.33 – 1.37, 5.57 to 5.62 and pages 79-80 and 111-112.

and will use that knowledge to help vulnerable SES customers and SWB is benefitting from Bristol's approach to C-Mex and leakage.

5.29 It submitted that the 'best of the best' approach means that these benefits can only be realised as a result of the merger and it would look to start leveraging best practice immediately following completion of the CMA's review. As to whether these benefits are likely to be sustained, Pennon points to the fact that it twice received fast track status for its business plan for its ability to understand customer views and to deliver and sustain what matters most.

Our assessment

5.30 High performing companies continuously learn from others and improve their performance without merging. For example, from 2021-22 to 2022-23 Northumbrian Water addressed its high leakage problem and reduced leakage by the largest percentage in the sector.[50]

5.31 Furthermore, it is still unclear to us over what time frame any service improvement benefits could be obtained. There remain differences in the performance levels of SWB and Bristol Water following the Bristol Merger. For example, Bristol Water has been one of the worst performing companies on per-capita consumption and this position has not changed following the merger. Bristol Water's per-capita consumption has slightly increased in 2022-23 compared with 2021-22 against the industry trend.[51]

5.32 We therefore do not consider that the merger provides relevant and specific benefits in terms of service improvements. Also, Pennon does not quantify the value of these benefits.

Environmental benefits

Pennon's view[52]

5.33 Pennon submitted that the merger would lead to environmental benefits. For example, Pennon said that SWB has an advanced, mature and innovative approach to catchment management and is seen by regulators and government as an industry leader in this field, and this knowledge would be introduced across the SES region. It also said that both SWB and SES have been leading in the delivery of leakage performance.

[50] See Ofwat, September 2023, 'Water company performance report 2022-23', page 13.
[51] See Ofwat, September 2023, 'Water company performance report 2022-23', pages 14-15, and December 2022, 'Water company performance report 2021-22', pages 15-16.
[52] See the MIA, paragraphs 5.63 to 5.67.

Our assessment

5.34 Firstly, our view is similar to the benefit discussed above (service improvements) in that companies can learn best practices and improve performance through means other than mergers. In fact, our regulatory framework encourages and incentivises improvement and we have seen companies improve over time with respect to eg catchment management, leakage, metering or meter reading technologies.

5.35 Secondly, with respect to its overall environmental performance, since 2011, SWB has consistently been given an EPA rating of one ('poor') or two ('below average') stars by the Environment Agency (with a 2 star rating in its most recent EPA report in 2022). It remains subject to our sector-wide investigation with respect to the operation and environmental performance of its wastewater assets.

5.36 While we certainly welcome the prospect of Pennon and SES learning and further developing initiatives that have the potential to improve their environmental performance, we do not consider these to be merger specific benefits. Pennon did not explain the timescale in which any such benefits would materialise or whether they would be sustained.

Improved financial resilience

Pennon's view[53]

5.37 Pennon submitted that the merger will improve the financial resilience of SES, including through Pennon's commitment to a £[REDACTED✂----] equity injection, which will reduce SES's gearing from its current level of [80-90]% and lead to the establishment of a more resilient service provider (both in terms of quality and price). Pennon says that [REDACTED✂----] and that it is committed to maintaining a responsible gearing range.

5.38 Pennon also expects SES to benefit from Pennon's track record of efficiently raising new finance.

Our assessment

5.39 SES is a highly geared small company. We recognise that an equity injection could improve its financial resilience. Pennon's planned equity injection is uncertain at this point. We would expect this injection to be a commitment if the merger is cleared.

[53] See the MIA, paragraphs 1.47 – 1.51 5.68 to 5.73 and page 77-78 and page 111.

5.40 Companies do not necessarily need to merge to obtain equity. There are public and private equity investors that could provide the funds. In 2023 Macquarie invested £550 million in Southern Water.[54] In light of this we are not convinced that the benefit is merger specific.

5.41 Furthermore, Pennon's valuation of the benefit at £[REDACTED✂----][55] (i.e. the full value of the equity injection) is inappropriate. We would expect Pennon to assess the impact of the £[REDACTED✂----] injection on the financial resilience of SES and how this leads to better outcomes for relevant customers.

Maintaining local presence

Pennon's view[56]

5.42 Pennon submitted that maintaining a local presence for SES, including local brand and operational leadership, is one of the benefits of the merger.

Our assessment

5.43 We note that absent the merger there would be no need to address the issue of preserving local presence for SES. We welcome Pennon's commitment in this respect, but we do not consider that the measures it identifies qualify as merger benefits. Pennon also did not explain how they would otherwise fulfil the criteria for assessment as potential RCBs.

Sector benefits

5.44 Pennon submitted that 'in addition to the RCB[s]',[57] which we discussed above, the merger would result in the following wider benefits to the sector:

- improved cost comparators;
- improved cost of equity assessments;
- increased presence of an investor with a long term focus on the UK water sector; and
- higher governance standards, transparency and openness.

[54] See Macquaire, August 2023, 'Macquarie Asset Management commits further £550 million to support Southern Water Turnaround Plan'.
[55] See the MIA, Table 29.
[56] See the MIA, paragraphs 1.45 – 1.46. A reference to maintaining local presence is also made on pages 18 and 79-80 and 111.
[57] See the MIA, paragraph 5.85.

5.45 We understand that Pennon does not consider these to constitute RCBs. We also note that wider sectoral benefits, to the extent that they relate to customers other than those of Pennon or SES, could not be considered RCBs in any event. As explained above, the 'relevant customers' for the purpose of the RCB assessment are customers of the merging parties (including customers at different levels of the distribution and production chains and future customers).[58]

5.46 To the extent any of the above benefits apply to Pennon or SES customers, we note the following:

- **Improved cost comparators**: Pennon submitted that SWB is a leading efficiency performer in the industry, whereas SES faces efficiency challenges. It says that the merger would allow Pennon to apply its operational excellence to SES without any deterioration in the efficiency of the merged company of SES and SWB, which should have positive implications on the efficiency benchmark for the sector as a whole.[59] [60] Similarly to our assessment of the claimed service improvement benefits above, we are not convinced this benefit would be merger specific as there are other means through which companies can improve their efficiency (and we have seen companies so improve from one price control to another). The impacts on the sector efficiency benchmark are linked to the way the benchmark is calculated (in this case, the way the upper quartile is calculated), as noted above in relation to the assessment of the impact on our ability to make comparisons. The merged entity would not provide additional information on what good looks like which could allow setting a more efficient benchmark for the sector.

- **Improved cost of equity assessments:** Pennon submitted that since its sale of Viridor it became a company focussed on UK water activities. As such it provides a third robust equity beta point for Ofwat, alongside those of Severn Trent and United Utilities, to help set the cost of capital for the sector. The addition of SES maintains the focus on UK water activities.[61] We note that Pennon is a FTSE 250 traded company whose beta information is readily available. The sale of Viridor created a pure water company and therefore contributed to the usefulness of SWB as a data point. The acquisition of SES would have no additional effect.

- **Increased presence of investors with a long-term focus on water:** Pennon submitted that it is committed to the UK water sector for the long-term and that its investment decisions will consider what is right for the SES region, and right for the

[58] Schedule 4ZA 7(4) WIA91. Sections 33A (Exceptions to duty to make a reference), 33B (Opinion of the Authority) and 33D (Undertakings in lieu of a merger reference) WIA91 use the definition of 'relevant customer benefits' that sub-paragraph 4.
[59] Oxera's work showed that beneficial outcomes for customers occurs in around 89% of modelled scenarios.
[60] See the MIA, paragraphs 5.74 to 5.76.
[61] See the MIA, paragraphs 5.77 to 5.78.

sector, both now and over the long-term.[62] We recognise that the purchase of SES is an important financial investment for Pennon that could add to its long term focus in the sector. However, SES already was a long-standing dedicated small water company that has been committed to the sector and the MIA does not explain why the merger would lead to better outcomes for relevant customers.

- **Increased governance, transparency and openness:** Pennon submitted that it was one of only three listed utilities in the water sector which would enhance transparency and allow for increased scrutiny of SES's performance following the merger.[63] We note that SES' performance is already reviewed by Ofwat and other regulators as well as various stakeholders who can access published regulatory information. The MIA does not explain how the inclusion of SES in the publicly listed Pennon group will lead to increased scrutiny of SES and better outcomes for relevant customers.

5.47 As above, while some benefits may qualify as potential RCBs in this merger, the parties have not provided sufficient evidence to demonstrate that they are certain, and we consider that their value is not as high as the estimates provided in the MIA. Overall, we consider that such benefits as could constitute RCBs would in any event not outweigh the prejudice to our ability to make comparisons to which this merger gives rise.

[62] See the MIA, paragraphs 5.79 to 5.80 and 5.86.
[63] See the MIA, paragraphs 5.81 to 5.83.

6. Customer support

6.1 Pennon's MIA refers to survey evidence it has collected from SES customers since the acquisition. In this section we summarise and assess that evidence.

Pennon's view[64]

6.2 Pennon submitted that customers support locally-run companies that are invested in the regions they serve and provide an ability for customers to have a say and a stake in their local water company. Customers also supported mergers that delivered real benefits to customers without any decline in performance and service.

6.3 Pennon submitted that the survey results relating to the merger showed customers:

- should have a say on how their local water company operates;
- viewed the Watershare+ scheme positively, even those that would not opt for shares;
- would welcome, all things equal, SES ownership by a UK FTSE listed business, while some would prefer public ownership;
- raised no concerns about the merger;
- wanted bills reduced while good service needed to continue; and
- wanted better information provision and engagement.

Our assessment

6.4 One of the criteria identified in the Statement of Methods for assessing company evidence is evidence of customer support.[65]

6.5 Customer views on mergers may be useful to highlight areas of concern or provide insight on the value they place on their water company remaining independent. However, customers cannot reasonably be expected to provide an informed view on how a merger might impact on our ability to use comparisons.

6.6 This is consistent with the CMA's decision on the Bristol Merger:

'Moreover, while properly-conducted survey evidence may be informative of consumer views, the CMA does not consider that this evidence is relevant for the purpose of informing any assessment of the statutory question, whether the Merger results in prejudice to Ofwat's ability to make comparisons between water enterprises and

[64] See the MIA, paragraphs 5.5 to 5.15.
[65] See Ofwat, 'Ofwat's approach to mergers and statement of methods', page 72.

whether any relevant customer benefits outweigh that prejudice. Pennon agrees with this view.

The CMA therefore has not given any weight to the survey evidence.'[66]

6.7 The survey evidence on customer support does not change our view that the prejudicial impact of the merger on our ability to regulate through comparative analysis is not outweighed by RCBs.

[i] The figure £[REDACTED✂----] at paragraph 3.32 should be deleted and replaced with the figure £[REDACTED✂----].

[66] CMA, February 2022, 'Completed acquisition by Pennon Group plc of Bristol Water Holdings UK Limited', paragraphs 176-177.