CONSUMER COUNCIL FOR Water

The Consumer Council for Water's submission to the Competition and Markets Authority on the Pennon Group / Bournemouth Water Investments merger inquiry

June 2015

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Introduction

The Consumer Council for Water is the statutory body representing the interests of household and business customers of water and sewerage companies in England and Wales. We operate through four Committees in England and a Committee for Wales.

On 15 April 2015, Pennon Group (owners of South West Water) acquired Bournemouth Water from Sembcorp Holdings Limited. The acquisition represents an incremental 5% growth in South West Water's Regulatory Capital Value.

Bournemouth Water (BWL) provides water services to a population of approximately 440,000 people in the Bournemouth and Christchurch areas.

South West Water (SWW) provides water and sewerage services to a population of approximately 1.7 million in Devon and Cornwall and parts of Dorset and Somerset.

We welcome the opportunity to provide a customer perspective on the merger of these two companies to the Competition and Markets Authority (CMA).

Executive Summary

The Consumer Council for Water (CCWater) is not against water company mergers provided that any detriment to the regulatory system or to consumers can be remedied so that it delivers measurable benefits for consumers.

Detriment to the regulatory system, and therefore customers, could be caused by a reduction in the precision of the comparative tools used by Ofwat to incentivise performance. For example, during the Price Review 2014 (PR14) Ofwat concluded that, for wholesale cost benchmarks, a merger of two companies might result in an altered efficiency challenge which could disbenefit customers. There is also the potential for successive water sector mergers to weaken Ofwat's efficiency challenge by reducing the number of comparators. Over time this could reduce the incentive on companies to drive operational and service performance.

Further detriment to customers could be caused by a loss of data that measures a company's performance in both absolute and relative terms.

All companies provide CCWater with a range of comparable performance data which we publish and use to push the poorer performing companies to improve. Data over the past four years shows BWL to be a leading company in terms of operational and customer service performance. SWW is a comparatively poor performing company for some measures.

If in approving the merger it led to a single dataset then this could:

- Mask the poorer performance of SWW and make it more difficult to press the merged company to improve.
- Lose BWL as an exemplar on a range of operational and service measures.
- Make it difficult to demonstrate to the customers of BWL that the takeover has not led to deterioration in services.

Given the above, we consider that:

- the CMA should make it a condition of this merger that separate reporting continues so that customers of BWL and SWW can be assured that the companies will deliver:
    - their respective 2015-20 performance commitments, reporting on an annual basis and in a way that is transparent to their customers; and
    - that there is no deterioration in service as a result of the takeover.

We would also like to see the merged company give a firm commitment, and for this to be reflected in the CMA's determination, to:

- share the cost savings arising out of the merger with both SWW and BWL customers within a year of them being realised, rather than them being wrapped up in the 2019 price review;
- maintain separate price limits for BWL and SWW to reflect the different environments they operate in;
- ensure customer service levels in the two constituent parts of the merged entity do not deteriorate, and where it does then customers deserve redress. This could be via the Service Incentive Mechanism and the Outcome Delivery Incentive system or, where these do not cover the failure, an additional sanction;
- seek to transfer best practice in one company in the other company and for this to be reflected in improved performance; and
- work with CCWater on those aspects of the merger activity that might impact on customer service.

Loss of a Regulatory Comparator

We believe that detriment to the regulatory regime and customers may occur if the merger is allowed to proceed without putting in place appropriate remedies. This could happen if the merger were to reduce the level of scrutiny that Ofwat (and other parties) would be able to make of the operational and customer service performance of the two constituent parts of the merged entity.

Detriment to the regulatory system

Detriment to the regulatory system, and therefore customers, could be caused by a reduction in the precision of the comparative tools used by Ofwat to incentivise performance. For example, during the Price Review 2014 (PR14) Ofwat concluded that, for wholesale cost benchmarks, a merger of two companies might result in an altered efficiency challenge which could disbenefit customers.

Furthermore, there is the potential for successive water sector mergers to weaken Ofwat's efficiency challenge by reducing the number of comparators. Over time this could reduce the incentive on companies to drive operational and service improvements to the disbenefit of customers more generally.

Similarly, reducing the number of comparators for the Service Incentive Mechanism (SIM) measure – especially if one of the comparators was a leading company - could lead to a convergence of scores and increase the 'noise' around the data. This would have two potential effects:

- middle ranking companies being given a SIM reward greater than they would otherwise have received had the leading company been included within the comparative analysis; and
- a consequent reduction in the ambition of companies to continue to innovate and drive up performance.

Detriment to customers

Water companies in England and Wales voluntarily provide CCWater with information about their customer service and operational performance on a quarterly basis. We publish annually the information we hold on companies' performance in our *'Delving into Water'* report[1]. We use the comparative information in this report to continue to push poorer performing companies to improve their performance by adopting industry best practice, where appropriate, or by developing innovative solutions to issues and service problems that customers view as important.

We, therefore, believe there is also detriment to customers more widely if the merged entity does not continue to provide separate operational and customer service performance data to Ofwat, CCWater and other parties. In particular:

- the good performance of BWL could mask the comparatively poor performance of SWW for some measures, and make it more difficult for CCWater to assess the extent of service improvements (or deterioration) in one or both of the merged companies;
- BWL would be lost as an exemplar on a range of operational and service measures; and
- it would be difficult to demonstrate to the customers of BWL that the takeover has not led to deterioration in services. This could cause concern amongst customers; one should not underestimate the differing levels of goodwill exhibited by the two companies' respective customer bases.

Benchmarking performance can inform CCWater's and stakeholders' challenges to companies, leading to benefits for customers.

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[1] 'Delving into Water' – Performance of the water companies in England and Wales 2010-11 to 2013-14
http://www.ccwater.org.uk/wp-content/uploads/2015/01/Company-performance-report.pdf

Delivering benefits for customers

There are three general areas in which we would wish to see the merger deliver benefits for customers; price reduction, customer service improvements and gain sharing.

Price Reduction

We would expect the merged company to share the cost savings arising out of a merger with the customers of both SWW and BWL at the earliest opportunity.

All mergers involving water companies have the potential to deliver operating expenditure savings from the removal of costs associated with:

(a) boards of directors, management team and company secretary;

(b) operations, including field staff and control room staff where it is practical to do so without risking service quality to customers;

(c) customer service (e.g. rationalising call centre arrangements);

(d) water quality (i.e. rationalising laboratory provision);

(e) information technology;

(f) finance, regulation and procurement; and

(g) human resources.

We have spoken to Pennon Group about its proposals for the merger in general terms but not about the level of operational cost savings it hopes to make. Nevertheless, we consider that the merged entity should be required to share whatever savings are made with their customers within a year of them being realised. Sharing cost savings early would be preferable to having the cost savings wrapped up in the next round of price setting, which in this case will be 4½ years away. This would demonstrate to customers that the merger is delivering benefits of which they will receive a share.

We recognise that merging companies may incur costs in the short term through the merging of IT systems in order to migrate data, redundancy payments, etc. However, these will be more than offset by cost savings.

We consider an appropriate balance needs to be struck between opportunities for cost savings and service quality. For example, centralising functions such as contact/call centres would be expected to save on operational costs, but this should not be at the expense of service quality. Cost savings could be shared through price reductions, extra support for vulnerable customers, improving customer services and/or undertaking additional work on the networks. We would look to work with the merged company on the detail of the sharing mechanism.

Any price reduction could be implemented through either a voluntary abatement of 'K' or a section 13 Licence amendment by agreement. The Competition Commission (CC) previously recommended a one-off lump sum transfer. If the CMA arrives at the same conclusion, the lump-sum transfer should be clearly marked and explained to customers.

Average household bills

Separate price limits for BWL and SWW should remain in place.

Customers of BWL have their sewerage services provided by either Wessex Water (WSX) or Southern Water (SRN). In 2019-20 the indicative average combined household bill for BWL's customers will be amongst the lowest in the sector. By contrast, SWW's customers will have a significantly higher combined water and sewerage bill by 2019-20.

Table 1: Indicative average household bill by 2019-20

Company	Average household water bill	Average household sewerage bill	Average household bill (combined)
Bournemouth Water (BWL)	£129		
Wessex Water (WSX)		£217	
Southern Water (SRN)		£254	
BWL & WSX			£346
BWL & SRN			£383
South West Water	£209	£297	£481*

All prices above are given in 2012-13 prices and exclude inflation

*The average combined household bill is not equal to the sum of the average household water bill and the average household wastewater bill due to the use of the economies of scope factor in the household retail price control.

Source: Ofwat's 2014 Final Determinations

We have received a verbal assurance from SWW that there will be no attempt to harmonise BWL's charges with those of SWW in the short, medium or long term. SWW recognises that the two companies' significantly different bill profiles reflect their different operating environments and that it would be wholly inappropriate to move to a common tariff. Moreover, SWW expects – subject to discussions around the Licence – that it will have separate price limits for the two companies at the next price review in 2019, and beyond. We expect Pennon Group to reassure BWL's customers on this point.

Customer Service

There are several aspects to this merger relating to customer service, across the range of measures monitored by Ofwat and CCWater, that we would like the CMA to consider in the round.

Maintaining separate reporting

We look to the CMA to make it a condition of this merger that separate reporting continues.

There are differences in how well the two companies perform in relation to customer service. We believe that one of the longer term benefits of a merger should be an improvement in the services delivered to customers.

However, we consider that there could be detriment to customers of both of the merging companies and customers more widely, if SWW and BWL were to combine their operational and customer service data. For example, the good performance of BWL could mask the comparatively poor performance of SWW for some measures, and make it more difficult for us to assess the extent of service improvements (or deterioration) in one or both of the merged companies.

Moreover, we and other parties, such as Ofwat and the Customer Challenge Groups (CCGs) across England and Wales, would lose BWL as an exemplary comparator. The challenge we, individually and collectively, would be able to make to companies elsewhere could therefore be dampened.

Ensuring no deterioration in service

We consider that the parties to a merger should provide a commitment that they will act to ensure customer service levels in the two constituent parts of the merged entity do not deteriorate.

This commitment could be enforceable through an in-period adjustment to price limits should performance levels fall in either or both constituent parts of the merged entity over the period to 2020. We acknowledge that the SIM and Outcome Delivery Incentive (ODI) frameworks exist to penalise poor performance, such as that which could arise from amalgamation of IT systems or consolidation of call centre operations. These frameworks should be used to their full extent at the next price review. Nevertheless, there may be some aspects of performance that fall outside the SIM and ODI frameworks, and customers deserve redress where there is deterioration in service.

The South East Water and Mid Kent Water merger clearly demonstrates why there is a need for such an undertaking. Although the CC determination stated that the merged entity should deliver a one-off price reduction of £4million in the 2007-08 charging year, there was no explicit requirement on the merged company to maintain service levels. The performance levels of the merged entity deteriorated in the immediate post-merger period.

Using comparative data to drive improvements

The information below, taken from our 'Delving into Water', 'Water Matters', and 'Complaint Handling in the Water Industry' reports, summarises both SWW's and BWL's recent performance against a range of operational and service measures. This illustrates why separate reporting for the two companies needs to continue.

Customer complaints

CCWater was formed at a time when complaints to water companies were rising rapidly. In 2007-08 written complaints to water companies peaked at 273,000. Since then we have used information about complaints to press all companies to adopt a 'right first time' approach to complaints management.

Over the past four years there has been a 34% fall in complaints from 185,140 to 123,218. While welcoming the continuing improvement, we continue to press the poorer performing water companies to do more work to bring them in line with better performers.

The table below shows that despite a decrease in the number of written complaints received over the four years, SWW's performance as measured per 10,000 connected properties remains poor in comparison to the industry average, and very poor when compared to BWL. While SWW narrowed the gap in 2011-12 and 2012-13 it fell back in 2013-14. It, therefore, has further work to do to improve its complaints performance and close the gap to the top performing companies.

We consider that in order for us to continue to push SWW to improve, its performance needs to be separately shown from that of BWL. Moreover, keeping BWL's data separate will give reassurance to customers in the Bournemouth and Christchurch areas, and to us, an early indication if services are deteriorating.

Table 2: Complaints performance of SWW & BWL 2010 to 2015

Written complaints	SWW		BWL		Industry	
	Number of complaints	Per 10,000 connected properties	Number of complaints	Per 10,000 connected properties	Number of complaints	Per 10,000 connected properties
2010-11	6,091	77.1	478	23.7	185,140	60.8
2011-12	4,518	56.9	465	23.0	163,027	53.2
2012-13	4,246	53.1	376	18.5	150,893	49.0
2013-14	4,477	55.6	368	18.0	123,218	39.8
2014-15*	4,036	50.0	342	16.7		

*The 2014-15 figures are unaudited and the industry average is not yet known

Service Incentive Mechanism

Company performance on complaint handling forms part of the Service Incentive Mechanism (SIM) which replaced the Overall Performance Assessment in 2010.[2] This new measure assesses companies' performance in handling contacts from customers, from telephone calls to written complaints, and includes a survey of customers with resolved company contacts. Companies' performance is scored out of 100. Refinements to the SIM were trialled in 2014-15 and came into force on 1 April 2015.

Table 3: Service Incentive Mechanism 2010 to 2014

Year	SWW	BWL	Industry Average
2010-11	58	82	69
2011-12	67	85	75
2012-13	71	87	79
2013-14	74	87	82

Whilst SWW has improved year on year, its SIM scores remain eight points below the industry average and significantly more so below BWL's scores. SWW still has much work to do in identifying and addressing the root causes of complaints. We will continue to work with SWW to ensure that the plans they put in place to address issues result in improvements and a more positive customer experience.

Interruptions to water supplies

Interruptions to water supplies can cause inconvenience to customers, especially if they occur at a time when customers would normally be showering or using water appliances. If the interruption occurs without warning due to, for example, a burst main the inconvenience can be that much greater. Yet customers accept that companies need to occasionally interrupt supplies to do planned maintenance – for which they receive notification – but they still expect them to be kept to a

[2] From 1999 to 2009 Ofwat used the Overall Performance Assessment (OPA) to measure and incentivise companies to improve services to companies. It worked reasonably well for the first five years, driving companies to address the underlying issues with poor service.

minimum and for communication about the interruptions to be clear and accurate to minimise disruption.

Table 4: The number of hours lost due to water supply interruptions for three hours or longer per property served 2010 to 2015

Year	SWW	BWL	Industry average
2010-11	0.82	0.06	0.34
2011-12	0.62	0.04	0.31
2012-13	0.27	0.07	0.27
2013-14	0.25	0.03	0.24
2014-15*	0.38	0.04	

*The 2014-15 figures are unaudited and the industry average is not yet known

A supply interruption is defined as when customers are without a continuous supply of water due to a planned or unplanned interruption and overruns of planned interruptions and interruptions caused by third parties.

As table 4 shows, SWW has improved its performance on interruptions to water supply for the four years to 2013-14. However, unaudited data for 2014-15, recently received from the company, shows deterioration in performance. Whilst BWL report a slightly worse performance in 2014-15, the company remains an industry leader in this area.

Once again, we consider that in order for us to continue to push SWW to improve, its performance needs to be separately shown from that of BWL. Moreover, keeping BWL's data separate will give reassurance to customers in the Bournemouth and Christchurch areas, and to us, an early indication if services are deteriorating.

Leakage

Customers have told us that their perceptions of their water company can be influenced by how they deal with leakage, and that this can also have an impact on customers' own efforts to save water[3]. While they do not expect leakage to be reduced to zero, they do expect companies to do more to fix leaks. They become particularly annoyed when, having reported a leak, the company does not repair it quickly or, if there is a delay, fail to keep customers informed about progress.

We are pushing companies to prioritise leakage and address the more customer facing aspects by producing the information customers find useful and demonstrating that they are tackling leakage. Some companies are rising to this challenge as they view active leakage control as part of both their wider water management activity and as a means to build a better relationship with their customers.

The table below shows the levels of leakage in megalitres per day (Ml/d) and the level of leakage as a percentage of the total volume of water put into the system each day by each company (the distribution input).

[3] Research into customers perceptions of leakage – http://www.ccwater.org.uk/wp-content/uploads/2013/12/Research-into-customer-perceptions-of-leakage.pdf

Table 5: Company leakage levels 2010 to 2015

Year	SWW		BWL		Industry average	
	Ml/d	% of distribution input	Ml/d	% of distribution input	Ml/d	% of distribution input
2010-11	83.7	19.8	22.0	14.5	161	22.8
2011-12	81.3	19.5	21.7	14.8	147	21.4
2012-13	84.2	20.2	20.9	14.3	147	22.1
2013-14	84.1	19.9	20.9	14.3	148	21.9
2014-15*	84.0	19.9	20.9	14.2		

*The 2014-15 figures are unaudited and the industry average is not yet known

BWL is one of the top performing companies in the industry in terms of leakage. The company has reduced leakage beyond its target of 22 Ml/d since 2011-12 and is committed to driving leakage down further to less than or equal to 20 Ml/d by 2019-20.

Since 2012-13 SWW has met its leakage target, and is committed to maintain leakage at 84 Ml/d for the five years to 2019-20.

Leakage is an important issue to customers as shown through not only our research, but also the two companies' respective PR14 customer research. Therefore, separate reporting needs to continue to demonstrate to BWL and SWW customers that leakage levels do not deteriorate.

Household customers' views on their water and sewerage services

Since 2006 CCWater has conducted research with household customers on an annual basis to allow us to better understand customers' views about water and sewerage services, and to track how, and for what reason(s), customers' views change over time.

Table 6 below shows household customers' views on aspects of the services provided by BWL and SWW.

Table 6: Household customers' views on their water and sewerage services 2011 to 2014

Indicators		SWW	BWL
Overall satisfaction with water supply	2011	86%	96%
	2012	86%	87%
	2013	92%	95%
	2014	94%	94%
Overall satisfaction with sewerage services	2011	82%	N/A
	2012	77%	
	2013	87%	
	2014	89%	
Satisfaction with value for money of water services	2011	35%	69%
	2012	53%	71%
	2013	51%	79%
	2014	56%	81%
Satisfaction with value for money of sewerage services	2011	39%	N/A
	2012	52%	
	2013	54%	
	2014	53%	
Agree charges are affordable	2011	51%	82%
	2012	56%	73%
	2013	48%	73%
	2014	58%	88%
Agree charges are fair	2011	31%	71%
	2012	43%	63%
	2013	29%	61%
	2014	46%	79%
Agree company cares about service given to customers	2013	61%	66%
	2014	67%	86%

N/A means not applicable

Note: Data for 2014 taken from CCWater's 'Water Matters 2014' survey, due to be published on 4th August 2015. This was based on a survey of 200 household customers of South West Water, and 150 household customers of Bournemouth Water.

It can be seen that the views of customers of SWW and BWL are similar in terms of overall satisfaction with water supply.

However, customers' views vary markedly on charges where over half of SWW's customers find their charges difficult to afford and a slight majority do not think their charges are fair. The fact that SWW's charges are the highest in England and Wales is a factor as is the below average income levels of their customers. As we commented at the time of publication of this research, all companies need to communicate clearly with their customers about the service improvements they will get in return for the prices they pay, and that help is available to those who are struggling to pay their bills. This is particularly true for SWW given their high bills and low value for money scores.

This illustrates the need for the continuation of separate price limits and the need for Pennon Group to give reassurance to BWL's customers about future charges.

Outcome Delivery Incentives

Ofwat's 2015-20 Final Determinations for SWW and BWL contained a large range of investments to improve the services that their respective customers had said they valued and wanted to see delivered. These should help improve performance across a range of services.

In many cases these investments have been linked to ODIs – rewards for outperforming targets and penalties for failing to deliver them. We will monitor companies' performance against these incentives, with particular attention on those that are customer-focused. And, where a company fails to deliver its commitments we expect Ofwat to take all necessary action.

Expectations on services

By the end of the transition period, we consider that the merged company should:

- **ensure that the best practice in one company is transferred to the other company and is reflected in improving performance levels; and**
- **achieve, or be showing progress towards achieving, customer service performance levels in the upper quartile of industry performance across the range of measures monitored by Ofwat and CCWater.**

Engagement with CCWater

We consider that there should be a role for CCWater as the statutory consumer body to work with the merged company on those aspects of its merger activity that might impact on customer service.

While we do not consider it appropriate for CCWater to be a member of the company's internal working groups, we do think it would be sensible of the company to provide us with:

- a timeline for achieving the merger, with targets and key milestones;
- early sight of its proposals so that we can comment on them and the company can make changes where required; and
- timely updates about progress in delivery.

We have a good and appropriate working relationship with both companies and have in the past provided feedback on a number of initiatives. This has been welcomed by the companies, and in many cases our comments incorporated in their policies and documents.

Gain / benefit sharing

BWL's gain sharing mechanism should be subsumed into that of SWW, should the sharing rate with customers of net financial gains - from beating their performance commitments and from unexpected financial benefits - be better than that proposed by BWL.

CCWater has long been concerned that Ofwat's price review settlements have turned out to be too 'generous' and that this has resulted in excess profits and high returns to shareholders; consequently, we have sought to obtain a share for customers.

Informal arrangements

In 2013 CCWater negotiated informally with all English companies[4] to share their excess profits with customers. Most companies responded positively to our call, and in total committed to return over £1billion to customers. Both SWW and BWL committed to sharing the benefits of operational and financial outperformance with their customers; £29million and £0.15million respectively.

Formalising gain / benefit sharing mechanisms

As part of building their 2015-20 business plans, companies developed a range of outcomes, measures and incentives. We pressed companies to consider a 'gain share' mechanism where they commit to sharing financial outperformance with their customers during the regulatory period. SWW and BWL proposed gain sharing mechanisms in their business plans and these have been included in Ofwat's Final Determinations for both companies.

SWW's gain sharing mechanism is known as 'WaterShare', a framework that allows for sharing benefits arising from the company's outperformance of Ofwat's expectations and other beneficial factors in a timely manner with customers. This mechanism protects customers and is one from which customers should gain.

The framework:

- monitors cost and outcome incentive performance from regulatory mechanisms;
- considers other performance areas of risk and opportunity ('other factors') that are not subject to regulatory mechanisms;
- appropriately shares net benefits to customers or highlights clearly the requirement for regulatory assessment of a net pain position; and
- reports and tracks performance annually.

'Other factors' include:

- changes in the industry assumed cost of new debt; and
- changes in taxation rates (e.g. corporation tax)

BWL's gain sharing proposals surround the sharing of unexpected financial gains with customers as soon as practicable. The mechanism will be gain share only. Total expenditure and outcome/performance commitment mechanisms will work independently of this proposal.

Whilst both companies have mechanisms from which customers should gain, we understand that the sharing rate with customers of net financial gains proposed by each company differs. We further understand from SWW that it is considering the introduction of a new 'WaterShare' mechanism for BWL customers but we have not yet seen the details of this.

[4] We did not approach the Welsh companies. Dŵr Cymru is styled as a not-for-profit company while Dee Valley made a slight loss over the two years.

We are of the view that, in principle, customers could benefit if BWL's gain sharing mechanism was subsumed into that of SWW. This should only occur if SWW's sharing rate with customers of net financial gains - from beating their performance commitments and from unexpected financial benefits - is better than that proposed by BWL.

Non-household retail services

SWW and BWL have subsidiary companies that were granted a retail water supply licence by Ofwat – Source for Business Ltd and Avon Valley Water Ltd respectively. The licence allows Source for Business Ltd and Avon Valley Water Ltd to operate anywhere in England and Wales other than the area of supply of their respective parent company.

We understand that Pennon Group intend to maintain Avon Valley Water Ltd and Source for Business Ltd as separate companies in the short term; i.e. prior to market opening and possibly for a period thereafter. We welcome this as it provides some certainty for customers of both companies.

If the two retailers are to continue as separate entities, Avon Valley Water's customers could have the choice to switch to Source for Business Ltd or vice versa. This would need to be communicated to customers and adequate time given to allow them to consider their options.

If Pennon Group subsequently decides to merge the two retailers then we would expect their customers to be advised of the change and receive the option to remain on the same price and service terms as before or move to the merged retailer's tariff(s) and service terms.

We would not want customers to experience any deterioration in the service levels currently offered to them by either Source for Business Ltd or Avon Valley Water Ltd by any enforced change of retail service provider.

Enquiries

Enquiries about this submission and requests for further information should be addressed to:

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