

COMPLETED ACQUISITION BY PENNON GROUP PLC OF BOURNEMOUTH WATER INVESTMENTS LIMITED

Statement of issues

3 July 2015

The reference

1. On 8 June 2015, the Competition and Markets Authority (CMA), in exercise of its duty under section 32(b) of the Water Industry Act 1991 (the Act), referred the completed acquisition by Pennon Group plc (Pennon) of Bournemouth Water Investments Limited (Bournemouth Water)¹ for further investigation and report by a group of CMA panel members (the inquiry group).
2. The CMA must decide:
 - (a) whether a water merger has taken place; and
 - (b) if so, whether the merger has prejudiced, or may be expected to prejudice, the ability of the Water Services Regulation Authority (Ofwat), in carrying out its functions by virtue of the Act, to make comparisons between different water enterprises (referred to as a 'prejudicial effect' in this statement).
3. In this statement, we set out the main issues we are likely to consider in reaching our decisions. This does not preclude the consideration of any other issues which may be identified during the course of our investigation.
4. Throughout this document, where appropriate, we refer to Pennon and Bournemouth Water collectively as 'the parties'.

Background

The parties

5. Pennon owns South West Water Limited (SWWL), a water and sewerage company (WASC) operating in the South West of England, and Viridor Waste

¹ Formerly Sembcorp Bournemouth Water Investments Limited.

Management Limited, a waste management company. The turnover of SWWL for the year ending 31 March 2014 was around £520 million in the UK (almost all of which came from regulated water and sewerage activities).

6. Bournemouth Water is the parent company of Bournemouth Water Limited, a water only company (WOC) operating in the Bournemouth area in the south of England. Its turnover for the year ending 31 December 2014 was around £49 million in the UK. As a WOC it does not supply wastewater services to its water customers which are instead provided by either Wessex Water or Southern Water. Customers receive separate bills for water and wastewater services.

The transaction

7. Pennon has acquired 100% of the issued share capital of Bournemouth Water and its subsidiaries from Sembcorp Holdings Limited, a Singapore based private equity company. This is an unconditional completed acquisition.
8. Pennon paid cash of £100.3 million (net of the assumption by Pennon of an inter-company settlement of £4.3 million due to Bournemouth Water). As part of the acquisition £86.9 million of external net debt and debt like items have been assumed by Pennon. Bournemouth Water had a regulatory capital value of £148.8 million as at 31 March 2014.

Assessment of the effect of the merger

Counterfactual

9. We will compare the effects of the merger to the counterfactual situation. We will therefore consider what would have been likely to happen if the merger had not taken place.
10. Currently Ofwat obtains information from the ten WASCs and eight WOCs in England and Wales for the purpose of making comparative benchmarking assessments.² After the merger Ofwat will have 17 independent comparators with which to make its benchmarking assessments.
11. We will also investigate whether there are any forthcoming regulatory changes in the industry which are sufficiently certain to be taken into account in our assessment.

² There are also six small local water companies with around 2,000 customers and 12 water supply licensees that are regulated by Ofwat, but these are excluded from Ofwat's benchmarking assessments.

Theories of prejudicial effect

12. We have set out below the theories of adverse impacts resulting from the merger which we intend to investigate. However, we may revise our theories as our inquiry progresses and new evidence emerges. The identification of a theory of adverse impacts does not preclude a prejudicial effect being identified on another basis following further work by us, or the receipt of additional evidence. We welcome views on the theories set out below.
13. The merger may have an adverse impact on Ofwat's ability to:
 - (a) set wholesale price controls;
 - (b) set retail price controls;
 - (c) monitor and incentivise service quality; and/or
 - (d) use comparisons to carry out ongoing monitoring and enforcement activities and to identify and spread best practice.
14. The adverse impacts discussed above in paragraph 13 may result from:
 - (a) a reduction in the precision of the comparative tools that Ofwat uses in its benchmarking. In this scenario a loss of a data observation, or the loss of a particular type of water enterprise, may result in Ofwat's comparisons being less precise; and/or
 - (b) the loss of a relatively efficient or high quality independent comparator that Ofwat uses in its benchmarking. In this scenario when relative measures are used in order to regulate water enterprises, the loss of a high performing benchmark may cause an overall worsening of the benchmark against which to measure other water enterprises leading to worse outcomes for customers; and/or
 - (c) the loss of a comparator with important similarities or differences for comparisons.
15. In undertaking our assessments we will take into account any potential changes to Ofwat's regulatory approach and the broader regulatory framework.
16. In all of areas listed in paragraph 13 we will take both a static and forward looking approach in our assessments. Moreover, we shall take into account both quantitative and qualitative evidence. For example, in addition to the impact on Ofwat's benchmarking analysis, we will also review the qualitative evidence on Ofwat's ability to use aspects of companies' actual performance

or business plans to demonstrate efficiency improvements or approaches to service quality which could deliver benefits to customers.

17. We will also consider the detriment to customers that may result from any adverse impact identified. We will then consider whether any adverse impact, on its own or taken together with any other adverse impact, amounts to prejudice.

Ofwat's ability to set wholesale price controls

18. Setting price controls for the regulated WASCs and WOCs is a key element of Ofwat's regulation of the water sector. Since water enterprises are regional monopolies (save for limited competition for large commercial customers), price controls are used to limit the prices that can be charged to customers, while allowing water enterprises sufficient income to finance efficient operations and investment. They are also used to incentivise companies to deliver improvements in service quality. Within the price control process, Ofwat uses benchmarking extensively to determine the level of efficient costs. Ofwat also uses comparisons more widely, for example in comparing business plans between companies.
19. The 2014 price review setting price controls for 2015 to 2020 (PR14) came into force in April 2015. Efficiency targets were set with reference to the upper quartile group of water enterprises based on Ofwat's econometric modelling. Wholesale water costs in PR14 were assessed using data to estimate total expenditure (totex) models.³
20. We will assess the impact of the merger on Ofwat's ability to set wholesale price controls by examining its likely effect on:
 - (a) the parties' costs used in the totex models;
 - (b) the efficiency level of the upper quartile group of water enterprises (both in terms of its absolute and relative levels) and the resultant efficiency challenge; and
 - (c) the precision of Ofwat's econometric modelling results.
21. We shall examine what level of cost efficiency the parties (together and separately) can be expected to achieve in the future relative to other water

³ Totex models assess all costs of a firm, rather than assessing operating expenditure and capital expenditure separately.

enterprises and particularly with respect to the upper quartile level. In doing so we shall examine how efficiency rankings have changed in the past.

22. We will also assess whether there are any features of the parties that make them particularly valuable comparators. For example, two water companies may operate in similar conditions and face similar issues that make them particularly useful comparators, or they may operate in a way that is a leading best practice that may allow Ofwat to spread such best practice approaches to other companies in the sector.
23. When assessing the merger's impact on the precision of Ofwat's econometric modelling results we will examine the effect using statistical theory and by estimating directly the impact on Ofwat's models. In this assessment we will take account of the reduction in data points available for econometric modelling. We will also take account of whether the parties are particularly similar, which may lead to greater (or less) consistency in the model. If the parties are especially similar it may be harder for Ofwat to establish what special factor adjustments should be made to the efficiency estimates.

Ofwat's ability to set retail price controls

24. In PR14 household retail costs were assessed using comparative company data to determine average cost levels, by adjusting a company's proposals with reference to an industry average cost to serve (ACTS) per household customer, based on historic costs. Companies that had costs above the ACTS were provided with a three-year glide path to achieve the industry ACTS. In future Ofwat has stated that it may use benchmarks based on an efficient cost to serve rather than calculate an industry average and we shall take this into account in our analysis as appropriate.
25. The merger may have an adverse impact on retail regulation if it leads to an increase in any cost-to-serve benchmark that would be in place absent the merger. We will assess the impact of the merger on Ofwat's ability to set retail price controls for households by examining the likely effect on the parties' cost to serve.
26. For non-household retail activities, PR14 set revenue controls for a period of two years (in recognition of the opening of the non-household retail sector to competition from 2017). The revenue controls were based on average retail cost for a given customer type plus a retail margin. We will assess the impact of the merger on Ofwat's ability to set retail price controls for non-households.

Ofwat's ability to monitor and incentivise service quality

27. After price caps have been set, water companies may have an incentive to lower the quality of the service that they offer in order to cut their costs. An important function of Ofwat is to ensure companies deliver the services that customers are paying for and to ensure that customers are protected in the event of a failure to deliver service requirements as well as to incentivise companies to deliver the levels of service expected.
28. In the past, Ofwat has made use of comparisons both in monitoring and incentivising water companies' performance. With respect to monitoring, simple comparisons have been used in order to identify and challenge relatively poor performers. For some aspects of performance, more formal league tables have been published serving a similar purpose.
29. League tables may also play a role in incentivising companies to improve their performance if there is a cost associated with being towards the bottom of the table (due to bad publicity or shareholder pressure, for example).
30. We will evaluate the importance comparisons have played in monitoring water company performance in the past and the parties' relative performance.
31. In PR14 Ofwat used an innovative approach of encouraging companies to agree appropriate outcomes with local stakeholders in the form of customer challenge groups. Companies supported their outcomes with a number of performance commitments, some of which were underpinned by financial incentive mechanisms known as outcome delivery incentives (ODIs). Many of these incentives were specific to each water company, although some were comparable across companies (such as leakage) and for some others Ofwat was able to make comparisons to assess company-specific targets.
32. However, where companies did implement (or were required to implement) similar ODIs across the industry, Ofwat made use of comparisons in order to assess company proposals and intervened to ensure companies were challenged to deliver a level of service quality.
33. Five ODIs were used by Ofwat in assessing comparative performance levels to determine an upper quartile benchmark for companies in the service that they provide to customers.⁴ Ofwat then introduced a glide path, with

⁴ These were: duration of supply interruptions, number of contacts from customers regarding quality of water, compliance with Drinking Water Inspectorate water quality standards, number of sewerage pollution incidents, and number of properties affected by internal sewer flooding.

appropriate financial incentives, for companies to achieve upper quartile performance by 2017/18.

34. We will take into consideration the merger's impact on this approach to defining targets for these ODIs and its subsequent impact on setting ODIs.
35. The service incentive mechanism is a financial incentive tool introduced by Ofwat to encourage companies to provide better service to customers by comparing service delivery. We will assess where the parties are ranked relative to other water enterprises, how the service incentive mechanism rankings have changed over time and how the merger is likely to impact on the relative and absolute performance of all water companies.

Ofwat's ability to use comparisons to monitor and enforce activities and to identify and spread best practice

36. Ofwat may use comparisons between water enterprises for monitoring and enforcement and to identify and spread best practice, thus improving the performance of the industry. Examples of areas in which Ofwat uses comparators to spread best practice include customer engagement, customer redress, affordability measures, board leadership and governance, innovative practices and in accounting and reporting of data. Specifically, Ofwat may make comparisons between the approaches taken by different companies to common problems in order to identify best practice, and then communicate this across all companies in order to improve efficiency across the sector. Ofwat may also compare the quality of water enterprises' business plans as a part of its review of price determinations. In PR14, Ofwat characterised this as a risk-based review, including identifying two companies as enhanced (of which SWWL was one), which resulted in a number of benefits for those companies.
37. The loss of a comparator may prejudice Ofwat's ability to use comparisons to promote best practice if the loss of an independent company causes the diversity of approaches taken to common problems to be lessened, and this effect is not offset by any countervailing effect in terms of a more innovative merged enterprise. This loss of diversity may then reduce the sector-wide scope for the development of innovative approaches, with the effect of reducing Ofwat's ability to identify and spread best practice.
38. In order to test the likelihood that this merger will prejudice Ofwat's ability to use comparisons to identify and spread best practice, we will consider:
 - (a) the extent to which Ofwat has used comparisons in the past in order to identify and spread best practice;

- (b) how innovative the two merging parties have been, and in how many instances they have contributed to industry best practice (and the importance of independent management to this); and
- (c) the extent to which the merged party will be more or less likely to develop innovative approaches to common problems.

Possible remedies and relevant customer benefits

- 39. Should we conclude that the merger has resulted, or may be expected to result in, a prejudicial effect we will consider whether, and if so what, remedies might be appropriate, and will issue a further statement.
- 40. In any consideration of possible remedies, we may have regard to their effect on any relevant customer benefits in relation to the merger and, if so, what these relevant customer benefits are likely to be and which customers would benefit and how.

Responses to the issues statement

- 41. Any party wishing to respond to this issues statement should do so in writing, by no later than 5pm on 17 July 2015. Please email pennon.bournemouthwater@cma.gsi.gov.uk or write to:

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