



Response to the CMA’s provisional findings of its investigation into the completed acquisition by Pennon Group plc of Bournemouth Water Investments Limited

Introduction

This submission sets out the response of the Water Services Regulation Authority (Ofwat) to the Competition and Market Authority’s (CMA’s) provisional findings¹ in its investigation into the completed acquisition by Pennon Group plc (Pennon) of Bournemouth Water Investments Limited.

The CMA has provisionally concluded² that the adverse impacts identified in its inquiry are not significant enough, either individually or in combination, to amount to prejudice to our ability to make comparisons between water enterprises. The CMA states it has provisionally concluded that the merger has not prejudiced, and may not be expected to prejudice, the ability of Ofwat, in carrying out its functions by virtue of the Water Industry Act 1991 (“the Act”), to make comparisons between different water enterprises.

While we do not oppose this merger, and consider the adverse impacts are relatively small (compared with some hypothetical transactions), we do consider that they are material and significant enough to amount to prejudice, and that this prejudice should be remedied in the best interests of customers. We therefore disagree with the conclusion in the CMA’s provisional findings.

¹ CMA 30 September 2015 “[Completed acquisition by Pennon Group plc of Bournemouth Water Investments Limited – Provisional findings report](#)”

² Paragraph 67 of the provisional findings

Summary

Overall, we welcome the approach adopted by the CMA to assessing the impacts of this merger. The approach follows that which we adopted in our initial submission to the CMA, which drew on the approach set out in our draft Statement of methods for assessing mergers under the revised special merger regime. We expect the revised special merger regime to commence in November 2015³.

However, we disagree with the CMA's assessment that the scale of adverse impacts is not sufficient, either individually or in combination, to amount to prejudice to our ability to make comparisons between water enterprises.

We quantify the adverse impacts in Table 1 with a central estimate of £67 million (within a range of £43 million to £113 million). These impacts are far more significant than the impacts that were considered sufficient to constitute prejudice in the Competition Commission's assessment of the South East Water / Mid Kent Water⁴ merger. They are also much larger than the adverse impacts found in the South Staffordshire Water / Cambridge Water merger where the Competition Commission found the impacts to be 'finely balanced'⁵.

The CMA has to decide whether this merger has prejudiced, or may be expected to prejudice, the ability of Ofwat, in carrying out its functions by virtue of the Act, to make comparisons. In carrying out its analysis, the CMA considers the impact of moving from 18 to 17 comparators; it notes that it cannot take into account further mergers in carrying out its assessment⁶. While we do not disagree with this interpretation of the CMA's required assessment under the Act, we note that the

³ The Water Act 2014 introduces a revised special merger regime for the water and sewerage sectors once the relevant sections are commenced by the Secretary of State. The revised special merger regime will remove the automatic referral of a merger that is captured by the current special merger regime to a phase 2 investigation in certain circumstances and allow the CMA to accept undertakings in lieu of a phase 2 investigation. The revised special merger regime will require the CMA to take account of our opinion in carrying out a phase 1 inquiry and in considering possible undertakings in lieu. The revised regime also requires us to prepare a 'Statement of methods' which sets out the criteria we will use to assess the impact on our ability to make comparisons and the weighting applied to those criteria. Following our consultation in May 2015, we published our final statement of methods [Ofwat's approach to mergers and statement of methods](#) in October 2015. That document sets out further detail on the revised special merger regime, the respective roles of Ofwat and the CMA and our approach to assessing impacts in the event of a future merger. The CMA has also consulted, in September 2015, on the revisions to its guidance in assessing mergers under the revised special merger regime in "[Draft guidance on the CMA's procedure and assessment in water and sewerage mergers](#)".

⁴ Competition Commission. [South East Water Limited and Mid Kent Water Limited](#). May 2007.

⁵ Competition Commission. [South Staffordshire Plc/ Cambridge Water PLC merger inquiry](#). May 2012. p. 6.

⁶ CMA provisional findings – paragraph 6.94

impacts of successive mergers on the precision of our econometric models is not linear and where good performing independent comparators are lost, it is all of the customers in England and Wales that bear the consequences of less challenging benchmarks. [REDACTED]

[REDACTED] In this context and given the fact that the CMA's final decision in its consideration of this merger is likely to set a precedent for consideration of future mergers, we consider the CMA should adopt a conservative, customer focussed, approach in assessing whether the adverse impacts are significant enough to constitute prejudice.

The adverse impacts are material when compared with the size of Bournemouth Water Limited (Bournemouth Water), whose turnover in 2014-15 was £47 million⁷. They are also material when compared against the synergy savings Pennon state will be achieved (c. [REDACTED] million per annum).

The CMA has not considered it necessary to consider the synergy savings Pennon say will be delivered. We consider these savings do not outweigh the adverse impacts which we and the CMA have identified; therefore we consider the merger does prejudice our ability to make comparisons. We consider the savings Pennon says it will deliver to be top end and uncertain – in addition, only a proportion of the stated synergy savings will be shared with customers and some of the benefits stated are not merger specific.

This merger involves the loss of a company with good performance, over a number of years, across a large proportion of the benchmarks we use. In addition, it results in the loss of an independently managed company in a regulatory system where our ability to draw comparisons is highly valued and where comparators are not easily replaced. In light of these factors, we consider the CMA should take a more conservative view when assessing whether impacts are 'significant enough'.

The CMA has placed significant weight on Pennon's views in relation to performance levels measured by the outcome delivery incentives and the SIM. We consider the weight the CMA has placed on these factors, while not considering it necessary to consider what benefits customers might actually receive both in terms of synergy savings and levels of service Pennon suggests will be achieved, places all of the risk associated with this merger with customers.

⁷ See p. 25 of [Bournemouth Water financial results 2014-15](#)

In summary, we consider the CMA should take a conservative assessment when concluding on the significance of the adverse impacts. We consider the CMA should set out the criteria against which it has reached its conclusion on the materiality of the adverse impacts it has found. We consider the CMA should consider whether it is satisfied that there are adequate mechanisms and incentives on the management of South West Water to deliver customers' share of the merger benefits that Pennon suggests it will be deliver.

It is our view that this merger will have a prejudicial effect on our ability to draw comparisons. While we do not oppose the merger, we do not consider the CMA's provisional findings to be in the customer interest (either in respect of the customers of Bournemouth Water, South West Water or water customers in England and Wales), nor would we find the final conclusions to be in the customer interest in the absence of any action to remedy, mitigate or prevent the prejudice to our ability to make comparisons.

Table 1 – Summary of the CMA's assessment of impacts and our view of quantified impacts (positive figures denote adverse impact)

Issue	CMA quantification	Ofwat view	Comment
Precision effect	£6.3 million per annum	£31.5 million over 5 years	We welcome the CMA's approach, however we consider the impact should be considered over the period of the price control. We do not provide a range for the precision effect.
Wholesale benchmark	£9 million (within a range of -£61 million to £9 million over 25 years)	£10 million (within a range of £6 million to £44 million over 25 years)	The CMA's assessment of £61 million benefit should be adjusted to recognise that rankings will change at PR19 compared with those forecast in PR14 business plans. The adoption of a changes matrix alters the assessment of £61 million benefit to £6 million detriment The CMA focus only on business plan rankings, we consider price review efficiency rankings should also be considered. However for the purposes of this merger we assume a £10 million central estimate, taking account of the CMA's views. The upper end of the range, £44m, is based on our assessment using historical ranks. Our central estimate is therefore a

Issue	CMA quantification	Ofwat view	Comment
			conservative estimate, at the lower end of the range.
Outcome delivery incentive benchmark	<£23 million (over 5 years)	£23 million (within a range of £6 million to £30 million over 5 years)	The CMA suggests that detriment is a maximum of £23 million and provides four reasons why the estimate is lower than £23 million. We provide representations on each of these issues and set out that we consider £23 million to be a central estimate. For the purpose of deriving a lower end total across effects under the CMA quantification, we assume an impact of £nil.
Service incentive mechanism	£2 million (within a range of -£0.5 million to £3.8 million over 2.5 years)	£8 million (within a range of £8m to £10m over 10 years)	Given Bournemouth Water's historic good performance and South West Water's historic poor performance, we consider impacts should be assessed from the point at which the merger occurs rather than once customer service activities are merged and that impacts should be assessed until 2025. We consider the CMA's range of impacts is unbalanced as it only considers scenarios where the performance of the combined entity is the same or better than current levels of performance. Our top end assumption (£10m) is based on the merged company performing at South West's level, which we consider to be a more likely scenario than some of the sensitivities assumed by the CMA.
Retail	-£27 million (within a range of -£2 million to -£27 million over 15 years)	-£6 million (within a range of -£3 million to -£9 million over 5 years)	Our range represents the most plausible set of convergence assumptions. We disagree with the CMA's sensitivity that produces a benefit of £27 million as it assumes companies with the most expensive cost to serve only start to catch up with the more efficient companies from 2020. Our range represents the two different convergence scenarios with our central estimate

Issue	CMA quantification	Ofwat view	Comment
			representing the mid-point of these scenarios (which is also consistent with our initial submission). Consistent with the SIM, both our estimates are until 2025 only. Beyond that point, we assume no impact as the benchmark may be more stringent or set by reference to external benchmarks.
Range	-£82 million to £40 million	£43 million to £113 million	Ofwat calculation of the impacts is based on the CMA assessment. The -£82 million impact assumes £nil impact on ODIs. Ofwat's range takes account of updated analysis based on the CMA's provisional findings and a five-year estimate of precision.
Central estimate of aggregate impact	£13 million⁸	£67 million⁹	Both central estimates include precision with the difference being the time period (Ofwat's 5 years vs. CMA's 1 year). The other main drivers of the difference are retail (-£9m vs. -£27m) and SIM (£8m vs. £2m).

The rest of this document is structured as follows:

- Materiality of the adverse impacts
- Precision of the econometric models
- Impact on the cost benchmarks
 - Wholesale costs
 - Retail cost benchmark
- Impact on the service benchmarks
 - Outcome delivery incentives
 - Service Incentive Mechanism
- Qualitative use of comparisons
- Benefits
- Corrections

⁸ Impacts assessed over different length as indicated in categories above

⁹ Impacts assessed over different length as indicated in above categories. Some time periods differ from the CMA assumptions.

Materiality of the adverse impacts

We consider the adverse impacts identified in this merger inquiry are sufficient to amount to prejudice to our ability to make comparisons between water enterprises. The CMA has not been explicit about the materiality thresholds it applies when assessing whether the adverse effects are sufficient for it to conclude prejudice has arisen and we recognise that this is a decision for the CMA. However, we consider it is reasonable to take a conservative view when assessing materiality for the purposes of assessing prejudice because the loss is to a system of regulation of monopoly service providers, particularly in circumstances where the loss to the system is a well performing comparator.

The previous decisions by the Competition Commission in the South East / Mid Kent Water and the South Staffordshire / Cambridge Water inquiries support the view that a conservative view should be taken. They also support the view that the adverse impacts arising in this instance are sufficient to amount to prejudice to Ofwat's ability to make comparisons and that the CMA should consider possible remedies.

In the South East / Mid Kent merger, the Competition Commission found it was likely the merger had a small adverse effect (i) on the precision of our econometric models, (ii) arising from the dispersion of standard cost-base estimates and (iii) on our qualitative use of comparisons. The Competition Commission found the adverse effects that resulted from the loss of precision were in an indicative range of £1 million to £10 million over one price review¹⁰. This was sufficient for the Competition Commission to conclude that prejudice had arisen.

In the South Staffordshire / Cambridge merger, the Competition Commission found that the merger could be expected to have a negative impact on our ability to make comparisons for the purposes of setting price controls. It quantified an adverse impact on the opex efficiency models of £4.0 million to £5.3 million over 30 years. Taking account of the impacts on the cost base, the informal use of comparisons, service quality and innovation, the Competition Commission found the assessment of impacts to be finely balanced and concluded on balance that prejudice did not occur¹¹.

Given these previous cases, and that the impacts on precision need to be assessed as more than a one year impact, we would ask the CMA to reconsider and set out its

¹⁰ See Competition Commission. [A report on the completed water merger of South East Water Limited and Mid Kent Water Limited](#). May 2007.

¹¹ See Competition Commission. [A report on the completed acquisition by South Staffordshire Plc of Cambridge Water PLC](#). May 2012.

findings in this inquiry in the context of the previous decisions of the Competition Commission.

We consider it is also relevant to assess the adverse impacts¹² against the proposed synergy savings. The proposed synergy savings of █████ million per annum also seem small compared to industry turnover (and customers will receive only a proportion of those savings). If they do not outweigh the overall industry detriment, it means that the generality of customers would have to pay more than if the merger did not occur. We consider also that even if the synergy savings do outweigh the adverse effects, this does not mean there will not be an adverse impact to the customers of some other companies.

Furthermore, we note some of the areas where we made use of comparisons at PR14 were not envisaged in the Competition Commission's previous assessment of the South Staffordshire Water / Cambridge Water merger. While the Competition Commission found in that inquiry that comparative competition would continue to play an important role in the future (paragraph 5.117 of the Competition Commission's conclusions), it also suggested that the broad themes arising from changes to the regulatory regime suggested the reliance we may place on comparators might become smaller going forward (paragraph 5.116). In fact, the use of comparisons made at PR14, which included the comparisons made throughout the risk based review, the introduction of ODI benchmarks and the introduction of the retail cost to serve benchmark suggests that the use of comparisons was at least the same, if not greater, than the use of comparisons that was made at previous price reviews. The methodology for the next price review is not yet set, and there are areas where amendments to our regulatory approach or the introduction of new policy means that comparators will continue to be beneficial to the regime in the future¹³. We consider this supports the view that the CMA should adopt a cautious approach in its assessment of adverse impacts.

To summarise, we consider the CMA should take a conservative approach to assessing the significance of the adverse impacts. We suggest the CMA considers the alternatives of assessing the significance of the detriment in comparison to previous Competition Commission decisions and the benefits proposed by Pennon.

¹² £35 million or £67 million (if precision is included)

¹³ We set out the areas where we might make use of comparisons in the future in section 1.3 of "Ofwat's initial factual submission to the Competition and Markets Authority following the acquisition of Sembcorp Bournemouth Limited by South West Water Limited" June 2015

Precision of the econometric models

In its provisional findings, the CMA place greatest weight on the General Approach; it has not placed weight on the Specific Approach because of econometric limitations or the Bootstrapping Approach because of technical econometric limitations. We welcome the CMA's use of the General Approach which it has applied largely in the form defined by Ofwat. We also welcome the proposal to place greatest weight on this approach.

We note that the £6.3 million (annual) impact identified by the CMA calculated from the General Approach is identical to our findings. The difference in percentage presentation is that our 7.5% is expressed as a percentage of inefficiencies to the average, while the CMA's 3.7% is a percentage of the mean deviation. We accept the CMA's presentation.

The CMA then states that although there is a loss of precision, it is not considered to be significant and is unlikely to reduce our ability to set cost-stretching benchmarks in the future¹⁴. The CMA states the revenue attributable to water wholesale activities (£5.2 billion) to set this figure in context.

As stated above, the CMA does not define materiality. However, as set out in Table 2 the impact on precision is very much greater than the impact found by the Competition Commission in the Mid Kent / South East merger where the precision impact was found to be in the range £1 million to £10 million over 30 years¹⁵. This compares to an estimate of £90 million if assessed over 30 years in this merger.¹⁶ We consider the precision impact should, as a minimum, be considered over the five year period of the price control as precision impacts on the assessment of costs over the full period of the price control. The figure we consider should be used to assess the precision impacts is therefore £31.5 million.

¹⁴ Provisional findings, paragraph 6.163

¹⁵ Paragraph 5.78 Competition Commissions [A report on the completed water merger of South East Water Limited and Mid Kent Water Limited](#) May 2007

¹⁶ We note that the price base is different but that does not change the conclusion.

Table 2 – Precision impact in previous inquiries

Merger	Loss of precision (%)	Loss of precision (£m)	Competition Commission/CMA classification
South West / Bournemouth	4%	£6.3m per annum	Not significant enough
South Staffordshire / Cambridge	2.73-3.41%		Detriment on opex
Mid Kent / South East		£1-10m (30 year NPV)	Small adverse impact – results in overall prejudice

As the CMA sets out, the precision of our econometric models is only one factor that we take into account in determining the benchmark set at future price reviews. However, precision is important as it impacts on the confidence we may have in assessing company business plans and special cost factor claims (where companies argue that our wholesale cost models do not represent their circumstances).

As stated above, we consider the CMA should consider the findings on precision in the context of its decisions in the Mid Kent / South East Water inquiry conclusions. And in that context, we note that we do not consider the current wholesale cost models to have inferior precision compared to the models considered in the Mid Kent / South East merger, which could possibly impact on the CMA's view as to what is considered to be a prejudicial. The models used at PR04 were based on a cross-section while the current models use panel data.

All else being equal, the use of panel data increases precision compared to cross-sectional data (due to an increased sample size), which was also noted by Pennon in their initial submission.¹⁷ For example, the current models are based on 90 observations (18 companies over 5 years) while the PR04 models used only 21 or 22 observations. However, the PR14 models are also more complex – as facilitated through the use of panel data.

¹⁷ Pennon Initial Submission, Annex B: Oxera Precision, page 3. Oxera stated “precision of econometric models improves significantly when using a panel dataset”.

The current models also perform better on a number of statistics, including R-squared.¹⁸ Furthermore, the triangulation of models at PR14 protected to some extent against imprecision of any one model influencing the final cost estimates. We therefore see no compelling reason why the definition of a significant impact as in Competition Commission precedent would not apply for this merger. In this sense the adverse impacts identified here would be considered significant.

We also consider that in making its final decisions, it is important for the CMA to consider the potential precedent it is setting for assessing merger impacts in the revised merger regime that we expect to be in place from Autumn 2015. To date the CMA has assessed precision on an incremental basis, i.e. assessing the impact of the loss of one comparator, and it has stated in its provisional findings that it cannot take into account the impact of further mergers on our ability to make comparisons¹⁹. However, we consider that when it comes to precision, the CMA needs to take a conservative approach as the true impact on precision may not be fully captured if the impact is assessed only by considering the loss of a single comparator in each merger inquiry.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Impact on the cost benchmarks

Wholesale costs

The CMA sets out a £9 million detriment to customers as its central estimate of the wholesale benchmark impact (CMA Scenario 2)²¹. This estimate is based on an approach proposed by Ofwat, in particular taking business plan ranks and applying a changes matrix to them to estimate positions for PR19 and onwards. The size of the impact is also similar to our analysis using the business plan approach (£10 million detriment). The difference is driven by two differences in the changes matrix – the use of a dead band around the new and the old upper quartile being identical²² and the weighting of ranks to account for historical mergers²³. As can be seen, these have a minor impact on the results.

We understand the CMA has discounted using the PR14 efficiency rankings on the basis that they result in a higher probability of Bournemouth Water being in the upper quartile at PR19 than is justified. Our view remains that efficiency rankings

²¹ Paragraph 6.158

²² The CMA assumes a small probability of the post-merger upper quartile being identical to the current upper quartile, which would lead to no impact on the benchmark. We do not make this assumption

²³ The CMA derives the rank of historically merged companies by taking the weighted average of their original ranks. We do not merge the historical ranks.

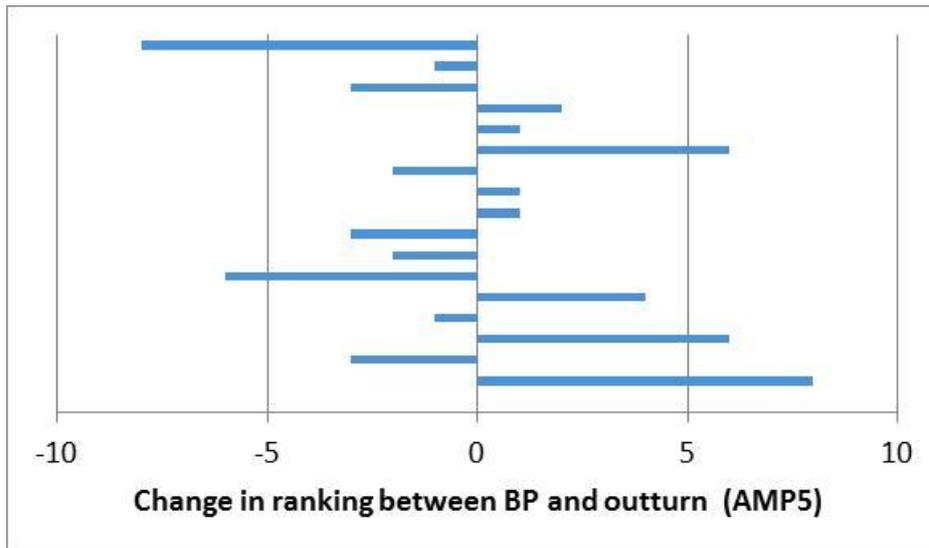
determined at a price review are informative in assessing merger impacts and that these are more informative than business plan rankings. We welcome therefore the CMA's comment that the use of business plan rankings is specific only to the current merger. We also welcome that the CMA has suggested that the modification of the supply demand balance model is only relevant for this merger analysis.

The CMA also states that it places some weight on an approach where the efficiency ranks at PR19 are identical to the business plan rankings from PR14 (CMA's Scenario 1)²⁴. We consider it unreasonable to place any weight on the CMA's Scenario 1. Business plan rankings and efficiency rankings do not serve the same purpose; business plan rankings do not allow for cost items that were not allowed in the final determination and there is evidence from previous price controls that shows that outturn ranks differ from business plan ranks. For example, there are clear incentives on companies to outperform their business plan assumptions that are prepared for setting price determinations. Therefore, the costs companies will actually incur in 2015-20 are unlikely to be the same as predicted in the business plans and we would expect as a result some movement in company efficiency rankings. This is a central principle in incentive based regulation and menu incentive mechanisms where companies are incentivised to beat the regulator's assumptions and their own business plan. Assuming that business plans represent the true efficiency over the next five years is therefore not in line with company behaviour. Furthermore, ranks are a measure of relative efficiency – Bournemouth Water's position does not only depend on its own performance but also on the performance of the rest of the companies over 2015-20. To place undue weight on business plan rankings would not appear to be a robust way to assess possible efficiency rankings at PR19.

We have previously presented evidence which shows the movement in company rankings from PR09 forecasts, which we re-present in Figure 2.

²⁴ Paragraph 6.159

Figure 2: Change in ranking from PR09 business plans to AMP5 outturn²⁵



We have not yet undertaken our assessment of company actual expenditure against forecast in 2010-15 for purposes of reconciling the PR09 regulatory incentive mechanisms as we do not yet have the capital cost inflation information available to carry out the assessment. However, we have carried out an initial assessment of outturn expenditure for South West and Bournemouth as set out in Table 3. Our initial assessment²⁶ shows that South West outperformed its business plan assumptions for water capital expenditure by 8% and Bournemouth Water outperformed its business plan assumption by 3%. These results further support the view that it is not reasonable to assume that business plan rankings should be fully indicative of the actual efficiency rankings based on outturn expenditure.

Table 3 – South West Water and Bournemouth Water performance in 2010-15 against PR09 business plan

£m 2012-13 prices	PR09 Business plan	PR09 Ofwat Baseline	2010-15 Outturn	Outperformance against business plan
South West – Water service	313.7	298.5	289.2	8%
Bournemouth – Water service	50.1	43.6	48.7	3%

²⁵ Based on actuals for 2010-2014 and forecast for 2014-15.

²⁶ This assessment remains provisional as outturn COPI data is required in order to make the final assessment.

Therefore, we consider that an estimate of no detriment (or £61m benefit) is unrealistic. A more realistic approach of estimating PR19 ranks (CMA Scenario 1) would be to apply a changes matrix to the business plan rankings based on the movements from business plan to outturn.²⁷ That changes matrix would show how company positions are likely to move from what they have set out in the business plans to what they actually achieve during the price control (based on the data shown in Figure 2). From there onwards, the original changes matrix would apply. This alternative approach yields a detriment of £6 million over 25 years²⁸. We therefore consider this provides a more relevant sensitivity than the one derived from Scenario 1.

Although the CMA finds an adverse impact using its Scenario 2 as the central case, it considers that the adverse impact is not significant enough to have an impact on our ability to set challenging benchmarks. As set out above, we consider the CMA should consider its findings in the context of previous merger assessments. We set out below CMA's assessment of this merger in the context of previous Competition Commission decisions.

Table 4 – Comparison of the CMA's conclusions in this merger to previous inquiries

Merger	Impact (£m 30-year NPV)²⁹	Competition Commission/CMA classification
South West / Bournemouth	£9m	Not significant enough
South Staffordshire / Cambridge	£4-5.6m*	Detriment

*Combined impact with precision

²⁷ Ofwat's Comments on Pennon's Initial Submission. July 2015. p. 11.

²⁸ We submit a spreadsheet which sets out this scenario with this representation.

²⁹ Price bases differ but the comparison still holds.

Retail

We welcome the approach the CMA has adopted to assessing the impacts on the retail benchmark, which largely follows the approach set out in our initial submission. As set out in our comments on wholesale, we have some minor differences of view on the changes matrix, but these are not material to the overall assessment. We accept that it is less informative to assess the impact using a static analysis³⁰ as we expect to move to an efficient (rather than an averagely efficient) benchmark in the future.

In assessing the range of impacts, the CMA considers a range of scenarios which take account of assumptions around the levels of convergence in company performance and the time period over which the impacts will arise. The CMA has not used any of these scenarios to take a central view of the impacts; it suggests that the key result, which is defined as whether the merger results in an adverse impact, is not sensitive to the convergence assumed³¹.

We consider it is important to assess the net impacts arising from the merger overall; in order to assess whether a net adverse impact arises in the overall assessment, this requires an assessment of the impacts to be made including in those areas where there may be a beneficial impact on the benchmark. Our view is that the assessment is sensitive to the assumed level and duration of convergence in company performance and so we comment on the convergence assumptions that have underpinned the CMA's analysis³².

Household retail price controls were set for the first time at PR14. Price controls were set on the basis of an average efficient cost to serve; the price control allowed companies that were assessed to be above the average efficient cost to serve to be remunerated on the basis of a three year glidepath to the average cost to serve.

As retail price controls were set for the first time at PR14, we have seen a significant increase in management focus in this area³³. As such we consider it is reasonable to assume that the increased management focus will drive the less efficient companies to start to close the gap with the more efficient companies from 2015. Therefore we disagree with the two scenarios used by the CMA which assume convergence will commence only from 2020; we consider these scenarios will overstate the possible benefit.

³⁰ CMA provisional findings paragraph 6.189

³¹ CMA provisional findings paragraph 6.193

³³ We provided examples in our response to the CMA's retail working paper.

In addition, given the uncertainty over the approach to determining the cost to serve in future reviews, and the potential for us to use non-water based comparisons going forwards we think it is reasonable only to assess the impact of the merger to 2025. This is consistent with the analysis we have carried out for the SIM (which is the performance incentive mechanism that applies to the retail control). We consider there is an inconsistency in the approach adopted by CMA if it places weight on an analysis of retail impacts beyond 2025 for retail but only until 2020 for the SIM.

We have represented the CMA's range of impacts assuming convergence commences in 2015, with impacts stated over the period 2020-25. We summarise our views in Table 5. We consider the best estimate of the impact lies towards the lower end of a range of £3 million to £15 million (from the range stated by the CMA of £2 million to £27 million), with an estimate in the range £3 million to £9 million to represent the most plausible outcome. We use £6 million as a central estimate which is consistent with our initial submission.

Table 5 – Ofwat assessment of the retail scenarios proposed by the CMA

CMA Scenario	Impact	Ofwat view
CMA Scenario 3 Convergence starts in 2015, with 75% catch up to the frontier by 2035	£3 million benefit (5 year NPV)	We consider this scenario represents a reasonable estimate of the impacts. We have corrected an error in the NPV calculation in the spreadsheet, which increases the benefit to £3 million over 5 years ³⁴ .
CMA Scenario 1 Convergence starts from 2020, to UQ in 2025	£9 million benefit (5 year NPV)	We consider convergence should commence from 2015 rather than 2020 and so this scenario overstates the benefit. Correcting this scenario for the same error as scenario 3 increases the benefit to £9 million over 5 years.
CMA Scenario 2 Convergence starts in 2020, with 75% catch up to the frontier by 2040	£27 million benefit (20 year NPV)	We do not consider this scenario to be valid. As stated above, we consider impacts should be assessed only until 2025 and convergence should be assumed to commence in 2015 to be

³⁴ We submit with a revised retail model with this submission.

CMA Scenario	Impact	Ofwat view
		<p>consistent with the underlying source of the assumption³⁵. Adjusting this scenario to assess impacts to 2025 reduces the impact to £15 million benefit (5 year NPV). But as stated above, we consider the convergence assumptions that underpin this scenario are not appropriate and we consider the 3rd scenario to be a more relevant assumption.</p>

Impact on benchmarks – service provision

Contrary to its view that the CMA does not need to consider whether Pennon's stated synergy savings will be delivered in practice, the CMA has placed significant weight on the statements and approaches set out by Pennon in assessing the performance delivered to customers as measured by ODIs and the SIM. The CMA refers to Pennon's statement that it will take the best of both companies in relation to ODI performance without setting out why it considers this assumption to be valid³⁶ and the CMA has considered only the scenarios where the SIM performance of South West and Bournemouth is at least as good as the past³⁷.

Bournemouth Water has demonstrated upper quartile performance in each of these areas and it is conceivable that performance in the Bournemouth region could deteriorate given South West Water's poorer track record and the expectation that the management practices of South West Water are most likely to prevail. With regard to SIM, the comparatively poor performance in the South West region could also deteriorate, at least in the short term, while retail activities are consolidated. To the extent the CMA takes account of the benefits that Pennon states will be achieved, the absence of any consideration of the weight it can place on those benefits materialising in practice, places all of the risk arising from the loss of a good comparator with customers.

³⁵ The assumption underpinning this scenario was the PR14 impact assessment. The PR14 impact assessment assumed convergence would commence from when the retail price control was implemented – i.e. 2015.

³⁶ Paragraph 6.259

³⁷ Paragraphs 6.281 and 6.282.

Outcome delivery incentives

We welcome that the CMA accepts much of our analysis of detriment in relation to outcome delivery incentives (ODIs) and say the evidence “suggests that the scale of the potential detriment (which would be within PR19) is around £23 million in total (over five years)” (paragraph 6.264).

We disagree with the four arguments put forward in paragraphs 6.266 and 6.267 about why the detriment will be lower than £23 million. In summary, the CMA argues that:

- Separate reporting will provide us with independent measures for a number of years
- Operational causes of water quality and supply interruptions are at least partly related to the performance of existing assets and operational management, which would lead us to continue to receive data that is at least partly independent
- We have indicated we would likely consider adjustments to ODI benchmarking at future reviews
- There is uncertainty in any forward looking analysis as ODI targets were introduced for the first time at PR14.

We discuss each of these issues below.

Separate reporting

The CMA argues that the detriment will be lower than £23 million because “the companies will retain separate reporting, and Ofwat will have independent measures for a number of years, at least up to most of 2015/16” (paragraph 6.266(a)). This paragraph implicitly acknowledges that South West Water and Bournemouth Water will not be independent comparators from 2016/17 onwards. Furthermore while we had separate data points for the Cambridge Water and South Staffordshire Water operating regions at PR14, we merged the data for the purposes of setting the upper quartile benchmark. The CMA's argument in paragraph 6.266(a) therefore does not lead to any reduction in the £23 million detriment because South West Water and Bournemouth Water will not be independent comparators during the period we are likely to use for setting benchmarks at PR19 and so there should be no reduction to our assessed adverse impact. Our view that the Bournemouth Water and South West Water data points are not independent would remain the case if we moved to

more forward-looking or dynamic benchmarks for outcomes for PR19 based on data for companies after 2019-20³⁸.

There is a risk that if we treat Bournemouth Water as an independent comparator when it is not and if performance for Bournemouth Water declines as the management practices of South West Water (a much poorer performer on the common ODIs) prevail across both operating regions then the ODI benchmarks we set could result in a detriment worse than £23 million as we would be including two poor performers in setting our ODI benchmarks rather than one merged poor performer.

Furthermore, we are likely to lose the separate reporting of South West Water and Bournemouth Water performance from 2020 onwards. There is no track record from PR14 of other companies that previously operated across separately licenced regions proposing separate ODI performance for ODIs where upper quartile benchmarks were set³⁹. For example, South Staffordshire Water did not propose separate ODIs for its South Staffordshire and Cambridge operating regions. Neither did Northumbrian Water, Affinity Water or South East Water for their separate operating regions.

Operational management and asset performance

In paragraph 6.266(b) the CMA states that “the operational causes of water quality and supply interruptions are at least in part related to the performance of the existing water assets and local operational management, and therefore separate reporting will be likely to result in Ofwat continuing to receive data that is at least partly independent”. The CMA accepts that the South West Water and Bournemouth Water data will not be fully independent in 2015-20, but downplays the role of company management in affecting performance which undermines the case for Pennon’s proposed efficiency savings which will be driven by a common management team across South West Water and Bournemouth Water. We provide further evidence to address this point below and we consider the argument in paragraph 6.266(b) does not lead to any reduction in the £23 million detriment because South West Water and Bournemouth Water will not be independent

³⁸ “There are also questions around whether the use of historical upper quartile benchmarks are sufficiently challenging and whether a more forward-looking approach would be more appropriate.” Page 22, Towards Water 2020 policy issues document on outcomes and customer engagement http://www.ofwat.gov.uk/pricereview/water2020/pap_tec201507engagement.pdf

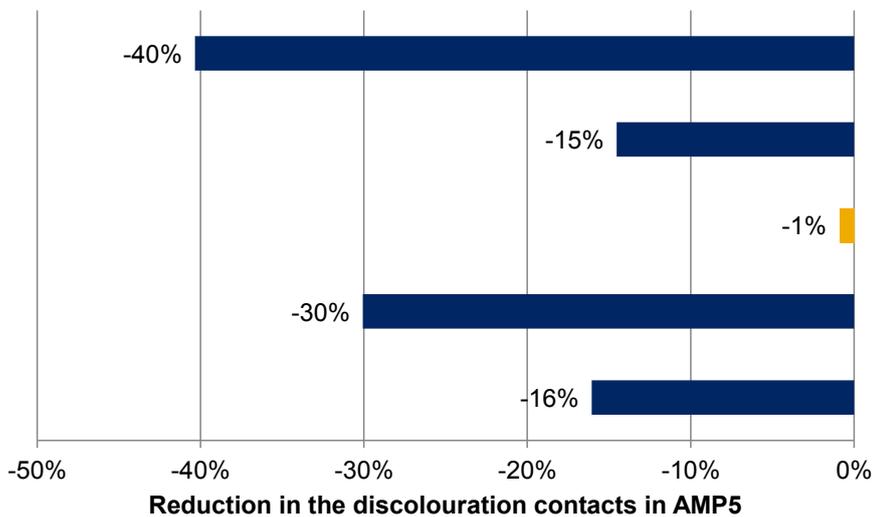
³⁹ The only ODIs where separate performance measures were set for different operating regions was in respect of leakage and only South Staffordshire Water and Northumbrian Water did this. This reflects the fact that company activities on leakage are more reflective of the economics associated with managing supply and demand in local areas.

comparators during the period we are likely to use for setting benchmarks for outcomes for PR19.

Water quality is not just driven by historical asset condition but also by management practices and management focus on certain areas. For example, on one of the relevant ODIs, discolouration contacts, South West has historically been the worst performer and remained the worst performing company in 2014-15.

Discolouration contacts are linked to mains renovation (renewal or relining). At PR09, South West received around £25m allowance for mains renewal (or 19% of its water non-infrastructure allowance, water MNI) – an amount similar to that of several other companies (with allowances of £23 million to £30 million over the same time period for mains renovation)⁴⁰. To put these figures in perspective, for the other companies – mainly WaSCs bigger than South West – they equated to a smaller proportion of maintenance non-infrastructure (between 7-19% for WaSCs) compared to 19% for South West. However, as illustrated in the Figure 3, South West has barely reduced its discolouration contacts (-1% or yellow bar), while the rest of the companies have improved their performance as a result of comparable if not lower renewal spend.

Figure 3 – Changes in discolouration contacts for companies that received mains renewal allowance for AMP5



⁴⁰ While others received zero special factor allowance.

Even if we do not express the change in percentage terms but in absolute reduction, South West still has shown much less improvement than the rest even after having spent a similar amount. This may indicate that despite the room for improvement, water discolouration has not been a priority for South West Water, which may be due to management focus rather than operational performance.

Future ODI benchmarking

The third argument for why the detriment should be lower than £23 million is that “Ofwat has indicated that it is likely to consider adjustments to ODI benchmarking at future reviews”⁴¹. However, the direction of travel in the sector is clearly in favour of more comparisons between companies’ performance commitments and ODIs.

We note that CCWater in its evidence to the CMA on 15 July 2015 and the Bournemouth Water Customer View Group in its evidence on 22 July 2015 both supported the comparative assessments for ODIs. In addition, the water companies have initiated the UKWIR⁴² benchmarking research project to identify key performance indicators which can be used for future comparative benchmarking.

In the Towards Water 2020 policy issues document on outcomes and customer engagement⁴³ we state:

“comparative information is extremely valuable information for customers and CCGs to understand the stretch of the proposed commitments and relative performance of their company.” (Page 19); and
“we are considering whether more comparative information should be made available to inform customer engagement earlier in the process and if so how this might be achieved.” (Page 22)

To the extent that upper quartile assessments are used to set ODI benchmarks in the sector in the future, we consider the loss of Bournemouth Water, as an independent comparator, given its good historical track record, will have an adverse impact on the benchmarks; in turn impacting on the levels of service received by all water customers in the future. Furthermore, the use of more comparisons of performance commitments and ODIs at PR19 could mean the detriment to

⁴¹ Paragraph 6.266(c)

⁴² UKWIR stands for United Kingdom Water Industry Research

⁴³ Ofwat, July 2015, “Towards Water 2020 – policy issues: customer engagement and outcomes”
http://www.ofwat.gov.uk/pricereview/water2020/pap_tec201507engagement.pdf

customers from the loss of Bournemouth Water as an independent comparator could be more than £23 million rather than less.

Uncertainty regarding future ODI benchmark targets

In paragraph 6.267 the CMA state “We have been mindful that ODI targets were introduced at PR14 and there is some uncertainty in any forward-looking analysis of the merger’s impact. As discussed, this uncertainty includes the reliability of quantifying the impact, rates of convergence in performance, how rankings between water companies may be expected to change and what threshold will be set in the future.”

We do not consider this to be a good reason for any reduction in the £23 million detriment. There will inevitably be uncertainty in the forward-looking analysis of any merger’s impact on both the potential benefits and the potential costs of a merger. The uncertainty could also mean the detriment is higher than £23 million rather than lower given the assumptions about the levels of convergence (using the scenarios illustrated in tables A21 and A22 of our initial submission, and adopting the same approach to calculating the £23 million adverse effect, we consider the central estimate is within a range of scenarios of £6 million to £30 million).

Furthermore, we note that the Competition Commission commented on the future use of comparisons in the South Staffordshire Water / Cambridge Water merger. While the Competition Commission found in that inquiry that comparative competition would continue to play an important role in the future (paragraph 5.117 of the CC’s conclusions), it also suggested that the broad themes arising from changes to the regulatory regime suggested the reliance we may place on comparators might become smaller going forward (paragraph 5.116). The use of comparative ODIs (or company specific ODIs) was not envisaged at the time of previous enquiry. We consider therefore the CMA should take a cautious approach in stating reasons why the impacts should be lower than what is already assumed to be a central view, particularly as the methodology for the next price review has not been set.

As with our approach to regulation, we consider it is reasonable for the CMA to make the best use of the information available to it in assessing the merger impacts. The assumptions that underpin the CMA’s assessment of £23 million adverse impacts to ODIs include assumptions about future levels of catch-up by the poorer performing companies and movements in rankings over time. While the assumption of no frontier shift could be considered to be a conservative assumption, we consider these assumptions already take a central view of possible impacts within a plausible range of outcomes. We consider that by suggesting the £23 million impact

represents an upper range of impacts, the CMA is placing all of the risk associated with the loss of Bournemouth Water as an independent comparator with customers.

Service incentive mechanism

We welcome the overall approach the CMA has taken to assessing the impacts arising for the SIM. However there are three areas where we disagree with the assumptions that have been made. These relate to:

- a different view on the approach to assessing the impact;
- the period over which the impacts have been assessed,
- the assumptions the CMA has made about the future performance of South West Water and Bournemouth Water relative to their peers; and,
- our view that separate reporting beyond 2020 should not be considered as a reason to mitigate the adverse impact.

Key differences in the approach adopted by the CMA

We have identified two key differences in the CMA's forecasting of SIM scores to the approach used by Ofwat.

The first difference is the way in which the CMA has forecasted the standard deviation of SIM scores. In our analysis this was done using a regression based on the scores for the existing 18 companies. This forecast was then used to calculate rewards and penalties in both the counterfactual case (18 companies) and the scenario with a merged entity. The CMA has added an additional step, whereby the regression is based on 18 companies to forecast the standard deviation for the counterfactual, but then conduct an additional regression based on a sample with the merged entity (17 companies). This second regression is then used in the forecasting of impacts in the scenario in which the companies have merged. We accept the CMA's approach to using different regressions for the counterfactual and scenario.

The second difference is the way in which the CMA has forecast the SIM scores themselves. We do not agree with the approach adopted by the CMA and we set out the difference between the CMA and Ofwat in the Appendix to this representation. A consequence of the CMA's approach is that the way it has matched the expected future rankings means that more than one company can have the same rank, and therefore be matched to the same SIM score and that some SIM scores associated with some ranks are never obtained. For example, in the first forecast year there are 2 companies ranked 3rd, 4th, 15th and 16th. Companies with the same ranking will then be given the same SIM score. Additionally, there are no companies with the

expected rank of 1, 2, 17 or 18. The number of double matching of ranks and SIM scores then increases as forecasts go further into the future.

We have also identified one spreadsheet error in the modelling that also caused a small difference in financial impacts. We have corrected this and amended our view of our central estimate of the impact on the SIM, which is now £8m detriment (taking account of our view of the appropriate time period as assessed below)⁴⁴.

Time period over which impacts should be assessed

Consistent with Pennon's approach, the CMA has estimated impacts from midway through 2017-18 because it has assumed any merger integration is unlikely to be finished until mid-2017-18. We took an earlier date as the date for the assessment of impacts as we consider it is the start, not the completion, of integration of South West Water's customer service functions that matter. Customers could, for example, receive adverse impacts on the level of service that specifically result from the merger. As SIM scores from 2015-16 onwards will be used for SIM rewards and penalties at PR19 and Bournemouth Water was acquired by Pennon on 16 April 2015, we consider it is reasonable to commence the assessment from 2015-16.

We consider this is a valid assessment, particularly in the case of this merger as:

- There is a significant difference in the SIM scores of Bournemouth (upper quartile) and South West (bottom quartile), which suggests customers in the Bournemouth region are more likely to receive lower levels of service in the future as the management practices of South West Water are the ones that are most likely to prevail.
- [REDACTED]

The CMA takes as its baseline position an assumption that impacts should only be assessed until 2020; impacts to 2025 are considered as a sensitivity. We disagree that the CMA should consider the impacts only until 2020 in its base assessment as there is currently no intention to remove the SIM at PR19.

⁴⁴ We submit a revised SIM spreadsheet with this representation.

Future performance of the merged entity

In its baseline assessment, the CMA has assumed the performance of the merged entity is the weighted average of the two parties' existing SIM scores. The CMA has carried out sensitivity analysis that assumes the merged parties have the same performance as the best of the two merging parties from mid-2017-18 onwards. This scenario drives one end of the CMA's stated range of impacts of a benefit of £0.5 million. However the CMA has not balanced this sensitivity with a scenario that assumes the merged parties have the same performance as the worst of the merging parties.

The CMA's sensitivity has a very low probability which requires significant improvements in performance in the South West region to move from its current bottom quartile position to upper quartile by mid-2017-18; Table 6 shows for example that no company in the bottom quartile in any of the years 2011-12, 2012-13 or 2013-14 was subsequently in the upper quartile in any of the years 2012-13, 2013-14 or 2014-15.

Table 6 – SIM performance rankings 2011-15

	2011-12	2012-13	2013-14	2014-15
ANH	5	5	4	3
WSH	8	6	7	8
NES	7	9	6	6
SVT	12	10	12	7
SWT	14	15	17	18
SRN	15	18	16	14
TMS	17	17	18	16
NWT	13	11	9	11
WSX	1	4	2	2
YKY	10	12	11	3
AFW	6	8	14	16
BRL	3	3	5	13
DVW	11	13	13	15
PRT	16	16	10	8
SBW	2	2	3	1
SEW	18	14	15	8
SSC	4	1	1	3
SES	9	7	8	11
UQ	5.25	5.25	5.25	5.25
BQ	13.75	13.75	13.75	13.75

Notes:

Figures in bold are upper quartile, figures in red are bottom quartile

For 2014-15 data:

UQW and SSC reported SIM performance using 2015-20 methodology

SVT and TMS did not publish a combined SIM score, so this is calculated one using the 2011-14 SIM weighting methodology

All other companies reported their 2014-15 SIM score using the 2011-14 methodology

Data for 2014-15 does not lead to financial rewards or penalties – it is available to Odp only

If we convert the ranks into movements across quartiles, we can see that only one company moved into the upper quartile (out of 54 changes across the four years) and that the majority of companies stayed in their original quartile (Table 7). In general, this indicates that there is not much movement between the quartiles and that it is very unlikely for South West to reach Bournemouth's performance across both operating regions within one price control.

Table 7 – Movements into and out of the UQ SIM rankings

SIM rank changes	Frequency	% of movements between quartiles
Firm moved into UQ	1	6%
Firm moves out of UQ	1	6%
Firm remained in UQ	14	88%

In addition, we have considered the impacts on the SIM where companies have merged their customer service activities. There are two examples to consider; in both cases, the SIM performance of the combined entity deteriorated below the level of even the worst performing company in the year immediately following the point that companies reported a single SIM score (Table 8); we note the performance of South West Water is markedly worse than the performance of the other companies in this comparison, and so we question why the CMA should accept any scenario where the performance in South West region is expected to improve in the absence of any robust evidence.

Table 8 – SIM performance of companies reporting a combined score

Merged companies	Pre-merger SIM scores			First combined score
	2011-12	2012-13	2013-14	
Affinity Water* (central)	78	80	N/a	79 (2013-14)
Affinity Water* (east)	85	85	N/a	
Affinity Water* (southeast)	80	83	N/a	
Cambridge Water	83	87	86	85
South Staffordshire Water	84	88	89	(2014-15)

Furthermore, we anticipate it will be the management practices of South West Water that prevail. In the absence of a formal undertaking, or for example, a revised ODI that confirms that management will deliver the stated level of performance across both regions throughout 2015-20, the scenarios used by the CMA are highly optimistic and would require a significant service improvement in the South West region even from 2015-16 as it is the overall SIM rankings at PR19 will be determined from overall SIM performance throughout 2015-19.

As set out in our previous submissions, we do not consider the service improvements that Pennon suggests it could derive could only be delivered as a result of the merger. In response to the CMA's working paper on SIM, we have provided the CMA with examples of step changes in levels of performance by other companies which have been delivered as a result of changes in management practice that have not been delivered as a result of a merger.

We have replicated the CMA's sensitivity assuming that the performance of the worst company prevails and we have submitted a separate spreadsheet to support this analysis. We consider this scenario to be more valid than the sensitivity where the CMA has assumed both regions perform at the level of Bournemouth Water. We assess that this results in an adverse impact of £7 million to 2025.

Separate reporting

The CMA appears to assume that separate reporting of SIM, on its own, will remove any adverse effect⁴⁵. We disagree that separate reporting of SIM performance should be seen as removing the adverse impacts that arise from the merger. SIM is an incentive mechanism that can be separately measured across regions, but we consider management style has a significant impact on SIM performance and so separate reporting in the South West and Bournemouth regions would not mitigate the effect of the loss of an independent comparator.

⁴⁵ For example, the scenario "separate reporting, baseline impact" has zero impact, as shown in Table 3 of appendix H.

Qualitative use of comparisons

We welcome the CMA's comments that there was merit in Ofwat being able to highlight best practice and encourage water companies to emulate it or adopt innovative approaches pioneered by other water companies. We note that the CMA has provisionally found there to be limited evidence that the loss of Bournemouth Water as an independently owned comparator would materially affect Ofwat's ability to spread best practice in the future.

The CMA states that any best practice specific to small water companies will impact on only a very small proportion of the overall industry and there will be limited opportunity for larger companies to draw lessons from them.

While we gave evidence of where we had used Bournemouth Water to provide examples of good practice to other small companies in the 2009 price review, this was largely in response to those small companies raising concerns regarding the difficulty of following the recommendations arising from the risk based review given their size. In these instances it was useful to use another small company such as Bournemouth to demonstrate that size should not be a barrier to producing a good revised business plan.

However, we may have equally used Bournemouth as an example to larger companies had a larger company produced a poor business plan or challenged the issues raised in the risk based review in an area not WASC specific. Many smaller water companies demonstrate leading practice in areas not dependant on size, for example in customer engagement. We cannot be certain what the standard of business plans will be from companies at the next price review and therefore we value those companies which produce good plans and demonstrate leading practice which we can use as examples to all companies, irrespective of size. Furthermore, it is currently the case that customers of any company cannot choose their supplier and therefore the service provided by each company matters and should not purely be considered in relation to the proportion of customers effected compared to the total number of customers across the industry.

Merger benefits

The CMA does not assess merger benefits (to South West and Bournemouth customers) in its provisional findings as it has not identified prejudice arising from the merger. However, should the CMA accept our representations such that it concludes the impacts are significant enough to amount to prejudice, we consider the CMA will consider the benefits Pennon has set out. We detail below the references to our comments on the benefits Pennon says will be achieved for the CMA's ease of reference.

We set out our assessment of the merger savings identified by Pennon in section 8 of our response to Pennon's initial submission⁴⁶. We set out the benefits stated by Pennon that we welcome, the areas where further evidence was required, we commented on the benefits to service performance claimed by Pennon and set out those benefits which we did not consider to be 'relevant customer benefits'.

As a part of the merger inquiry process, Pennon subsequently provided external assurance on the synergies it expects can be achieved. We subsequently set out to the CMA that:

- The assurance statement related to a review of quantified financial savings and the assumptions. It was not based on an assessment of a detailed implementation plan.
- It did not include an assessment of the costs related to delivering synergy savings [REDACTED]

- [REDACTED]
- [REDACTED]
- [REDACTED]

As set out previously we would expect to see a commitment or undertaking from Pennon that these savings will be achieved, so that we can be certain that the synergy savings set out will be achieved and that customers will share in the merger benefits.

Corrections

We have identified the following corrections which we consider should be addressed in the final report.

Paragraph 6.236 – the overall performance assessment (OPA) was the predecessor measure to the SIM, although it did pre-date ODIs. We suggest the following change: "...in the overall performance assessment – a predecessor measure to the **SIM** designed to improve performance in core services **which pre-dated ODIs** – was historically much faster."

Paragraphs 6.238 to 6.244 and Appendix G paragraphs 27 to 29 - you need to replace "hours" with "minutes" for supply interruptions.

⁴⁶ Ofwat comments on Pennon Plc's initial submission to the Competition and Markets Authority (CMA), July 2015

Paragraph 6.74 – This paragraph should be put into context. This analysis was done in the context of refuting the proposition by Pennon and the CMA that in the Ofwat's General approach we had not adjusted by different UQ targets when perturbing the average line by plus/minus one prediction error. This analysis was done for demonstration to show that ideally one would separate the two impacts. We recognised that what we estimated did not constitute a confidence interval around the UQ benchmark and we therefore did not place any weight on this.

Footnote 106 – It should be noted that the 3.8% is from a slightly different calculation of General approach to the 7.5% quoted in paragraph 6.78.

Paragraph 6.114 – Should say “statistically insignificant”.

Paragraph 6.276 – should reflect our comment on paragraph 57 of the summary document. We have not said that the SIM ‘would’ be replaced after 2025. We think it better to state that “Ofwat assumed a high degree of convergence performance after 2020 and so assumed in its submissions that the SIM would be replaced after 2025 and so we have not....”.

Appendix D, paragraph 6 – The last sentence could be clarified. Does the CMA mean to say that we are assuming that measuring impact on precision of historical econometric totex equates to changes in level of precision of forecast totex (i.e. AMP6)?

Appendix D, footnote 8 – Typo: “we means”.

Appendix D, paragraph 29 – Still have the description of inefficiencies backwards, as mentioned previously in our putbacks.

Appendix D, footnote 17 – Second sentence, should be clear that “These” means the BCT.

Appendix D, paragraph 30 – Should read “Ofwat then uses the **absolute** average of the **absolute** bias...”.

Appendix D, paragraph 35 (a) – This measure is based on CC precedent. Furthermore, it is mathematically equivalent to taking the width of the confidence interval as the relative comparison to actual costs (from where inefficiencies come) cancels out. Normalising by industry inefficiency is done for presentational purposes. The main difference to what the CMA has done is therefore in presentation, not in substance.

Appendix D, paragraph 36 – Same comment as para 6.74.

Appendix D, paragraph 42 – Same comment as for para 35.

Appendix G, paragraph 6 – we set upper quartile benchmarks for 2015-20 (not 2014-19)

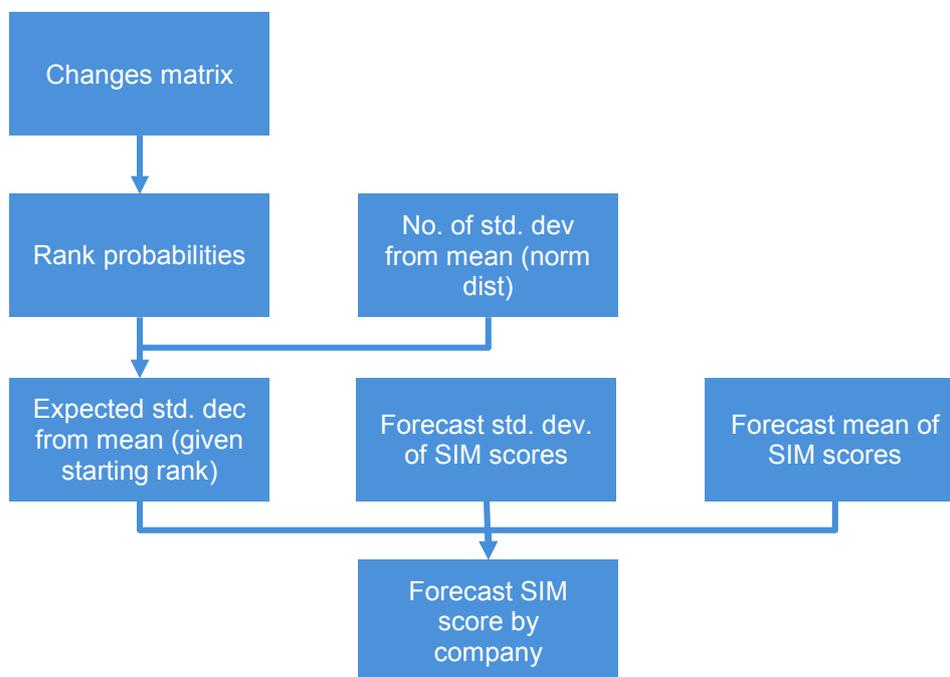
Appendix G, paragraph 37(b) – it would increase transparency if you made the following addition: “Past convergence in **Ofwat’s** overall performance assessment scheme”

Ofwat
October 2015

Appendix – differences between the CMA's and Ofwat's approach on SIM

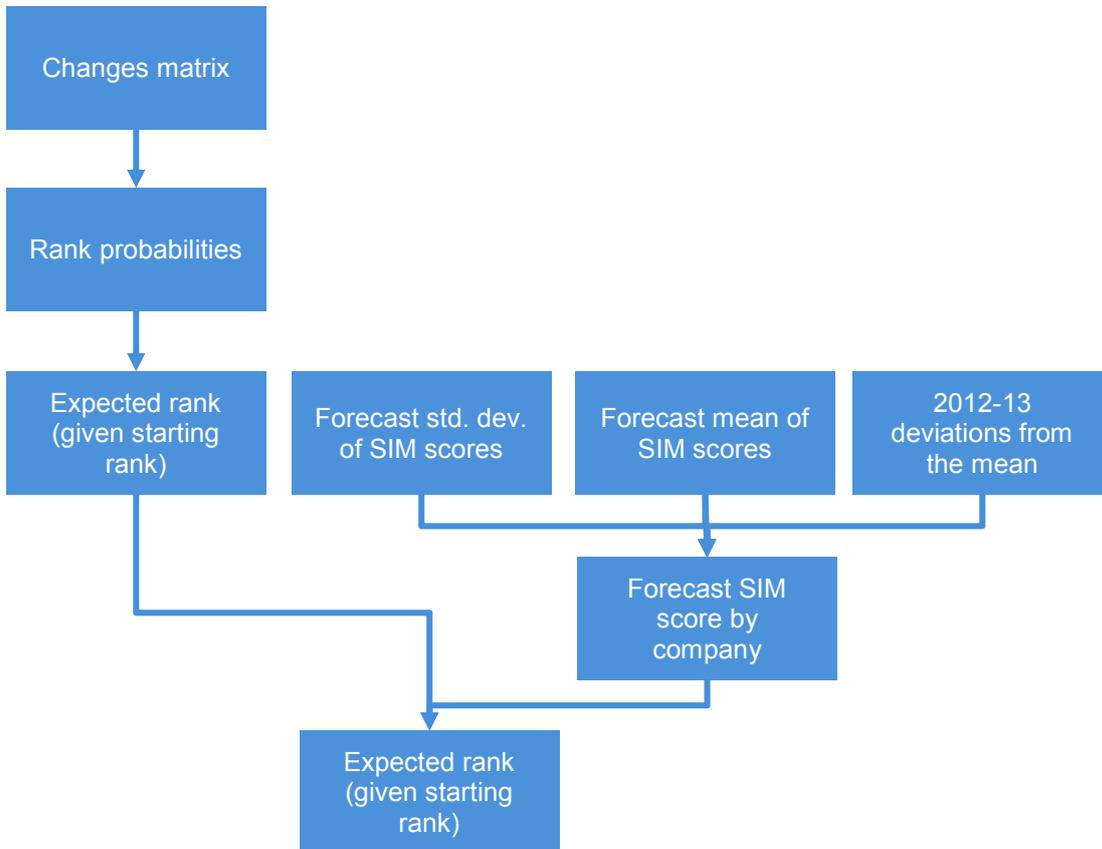
Our approach used a changes matrix to forecast the probability of companies being a particular rank in the future (in terms of standard deviations from the mean), and multiplied this by the number of standard deviations from the mean taken from a normal distribution for each rank (this distribution was assumed constant over the forecast period). Given an initial starting rank, this gave the expected number of standard deviations from the mean for each forecast year. This was then combined with forecasts of the mean SIM score and standard deviation to give a forecast SIM score for each company. The general flow of calculations is represented below.

Figure A1: General flow of calculation in Ofwat's assessment of impacts on the SIM



The CMA's approach is different. Instead of calculating the expected number of standard deviations from the mean, it calculates the expected ranking of companies in the future (given an initial starting rank). The CMA then matches this with the expected rank to SIM scores that have been forecasted separately. The forecast of SIM scores is based on the distribution of standard deviations from the mean in 2012/13 and the forecasted mean and standard deviation of SIM scores. The general flow of the CMA's calculations is represented below.

Figure A2: General flow of calculation in CMA's assessment of impacts on the SIM



A consequence of the CMA's approach is that the way it has matched the expected future rankings means that more than one company can have the same rank, and therefore be matched to the same SIM score and that some SIM scores associated with some ranks are never obtained. For example, in the first forecast year there are 2 companies ranked 3rd, 4th, 15th and 16th. Companies with the same ranking will then be given the same SIM score. Additionally, there are no companies with the expected rank of 1, 2, 17 or 18. The number of double matching of ranks and SIM scores then increases as forecasts go further into the future.