BRISTOL WATER

PR19 Redetermination

Bristol Water:

Reply to Ofwat’s further submission

July 2020

Reply to Ofwat's further submission of 22 June 2020

1. Introduction

1 In this document we provide the CMA with high level observations on Ofwat's further submission of a response to our 27 May reply on 22 June 2020 (**Ofwat's June submission**).[1] Overall, we note that there is nothing in Ofwat's June submission that has a material bearing on the arguments set out in our Statement of Case and Reply.[2] We consider that the CMA has the relevant material in these documents to reach an informed view on Bristol Water's price control. Nevertheless, to assist the CMA we have duly responded to the points raised by Ofwat and explained why these can be dismissed.

2 In responding to the June 2020 submission, we have primarily focused on those issues identified as "new points" in Ofwat's letter of 25 June 2020 (**June letter**) (see section 2 below). We also clarify two points raised in Ofwat's June submission that were not specifically identified in the June letter (see section 3 below).

3 In Ofwat's June letter, Ofwat comments on what it describes as a number of "*new arguments*" from Bristol Water. We disagree that these arguments are in any way new. Ofwat merely highlights areas where we and Ofwat are in dispute. The only aspects that could be considered "*new arguments*" are in relation to Ofwat's substantial repositioning of its reason for not allowing Bristol Water a Company Specific Adjustment (**CSA**), which has moved from being a question of customer benefits to one of embedded debt, and Ofwat's new analysis by Europe Economics on the CSA, which Ofwat presented as part of its response to our Statement of Case, dated 4 May 2020 (the **Response**).

4 To assist the CMA, we also provide in Annex 1 an index to where information relevant to Ofwat's additional submission can be found in our Statement of Case or our Reply. We provide brief comments on our views by exception.

2. Issues identified in Ofwat's letter of 25 June 2020

5 We set out below our high level views on those points where Ofwat asserts in the June letter that Bristol Water has included new arguments. In relation to each of these areas, we do not accept Ofwat's characterisation of our arguments as "*new*". Rather, they are responsive to specific points raised by Ofwat in its Response.

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[1] We focus on the BRL company specific document, Ofwat (June 2020), 'Reference of the PR19 final determinations: Response to Bristol Water's 27 May submission to the CMA' (**Ofwat's June BRL submission**), as what Ofwat describe as "cross-cutting" issues does not appear to be new evidence that relates to issues we have raised in our reference. We find it difficult to unpick from what are described as "cross-cutting" issues the aspects Ofwat want to address against our statement of case.

[2] Bristol Water's statement of case, submitted on 2 April 2020 (the **Statement of Case**) and Bristol Water's reply to Ofwat's response, submitted on 27 May 2020 (the **Reply**).

2.1 Company specific adjustment – absence of new evidence

6 In its June letter, Ofwat states that we have raised new arguments on its updated small company premium (cost of debt) estimate and new evidence on the customer testing of the cost of equity uplift and annual bill uplift. It states that these points are addressed in paragraphs 2.4 to 2.20 of Ofwat's June BRL submission.

7 It is incorrect to describe these points as new arguments. The only new arguments raised were in response to Ofwat's repositioning of the CSA issue as an 'embedded debt' issue for Bristol Water, and in response to the analysis by Europe Economics that was submitted with Ofwat's Response of 4 May 2020. The Europe Economics evidence was a substantial piece of new evidence that contradicted Ofwat's previous position on the cost of debt CSA throughout PR19 up to the point of the Response and therefore merited detailed consideration in our Reply of 27 May 2020.

8 Notwithstanding that these are not new arguments, we make the following observations should the CMA wish to take Ofwat's further submission into consideration.

9 In relation to the cost of debt CSA (paragraphs 2.2 to 2.10 of Ofwat's June BRL submission):

- Ofwat merges the new to embedded debt ratio with the small company embedded cost of debt difference in its analysis.[3] These are separate issues, as historical embedded debt costs relate to small company features, whilst the new to embedded debt ratio relates chiefly to the enhancement programme. This latter issue has not just been raised by water only companies.

- Ofwat claims that the industry cost of debt includes small WOCs. This is not correct. During PR19, Ofwat decided to use an embedded debt median point estimate for WaSCs and large WoCs[4] specifically to exclude the higher debt costs of smaller companies, with Ofwat's position being that small companies could ask for a CSA.[5] This analysis excluded Bristol Water's debt costs. Ofwat's submissions on the cost of debt CSA in its Response and Ofwat's June submission therefore contradict its approach during PR19 from the methodology consultation onwards. Indeed, in Ofwat's FD, Ofwat based its decision to disallow Bristol Water a CSA cost of debt uplift solely on the customer benefits test.[6]

- Ofwat has not provided supporting spreadsheets and evidence for the new calculations it refers to in paragraphs 2.5 and 2.6 of Ofwat's June BRL submission. Therefore, we have not been able to fully analyse these calculations.

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[3] Ofwat's June BRL submission, paragraphs 2.17.

[4] Ofwat 'PR19 final determinations: Allowed return on capital appendix; Table 6.2, page 90

[5] Ofwat (December 2017) 'PR19 final methodology Appendix 12 Risk and return', page 80:
"*We set out in section 7.3.3 our view that we may consider it reasonable to award a company-specific uplift to reflect a higher cost of embedded debt due to a company's small size; where there is compelling evidence that customers will benefit and support the proposal. Our early view is based on a median of company-level debt costs across the sector, however, we note that using a median for WaSCs and two large WoCs would lower the cost of embedded debt to 4.44% (Table 9). This would likely represent a more cost-reflective allowance for the rest of the sector if we considered it appropriate to set a separate allowance for the smaller WoCs based on their particular circumstances. We will revisit our assessment in the draft and final determinations.*"

[6] Statement of Case, paragraph 158.

- Without this data, we believe the conclusions are inconsistent with logic. In any case they do not support Ofwat's denial of the existence of a size premium for Bristol Water as an assumption, something that the CMA found in 2015 and Ofwat's own methodology relied on in setting the industry embedded cost of debt.

- Ofwat repeats points it has made previously that our cost of debt is lower than some WASCs. We addressed this issue in paragraph 120 of our Reply. Our case focuses on the cost of debt for a small company against the Ofwat benchmark. Ofwat's analysis conflates timing of issuance and the size premium. It is possible that some companies issued debt a long time ago and carry large or expensive debt. This does not deny the existence of a CSA on debt.

10 On the cost of equity CSA (paragraphs 2.11 to 2.20 of Ofwat's June BRL submission):

- Ofwat states we have confirmed that our main argument for a cost of equity uplift derives from a comparison of "thinner margins" using the 'operating cash flow to revenue' and 'RCV run off and return on capital to final allowed revenues' ratios.[7] This is incorrect. We maintain that there is a range of evidence that must be considered. We have openly presented a range of evidence on the cost of equity uplift throughout the PR19 process and weighted it carefully to try and focus on arriving at a balanced judgement and determination.[8]

- Ofwat does not dispute that systematic risks exist, or that small water companies face greater volatility of returns (i.e. higher fixed costs and penalties when compared to a lower relative RCV) when faced with water-sector systematic risk shocks (which can include, amongst other things, common ODI measures given the weighting to underperformance, localised adverse weather impacts, macroeconomic risks to the supply chain and the cost of the increasing regulatory burden). In any case, the past consideration by the CMA of the small company cost of equity uplift has not required the excess volatility to be systematic. Rather than taking this position as fixed, we tested the evidence in the FD as to standardised downside risks in order to address the challenge that the volatility was due to a factor that was not reflected in the risk facing the notional comparator.

- It is not a new observation that some of the operational gearing metrics show a wide range of impacts across companies. This is consistent with the findings in CC10 and CMA15,[9] and the Economic Insight analysis we presented in response to the Draft Determination. That is why we explored the RORE skew as an additional area of cross-check of the logic that an uplift to the cost of equity for a relevant notional small company such as Bristol Water was justified (which Ofwat chose not to address by stating it is not a focus of our argument), as well as proposing that a number below the minimum level of the current analysis (i.e. at a level consistent with the previous CMA decision as to the level of uplift) was a balanced judgement.

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7 Ofwat's June BRL submission, paragraphs 2.14 and 2.15.

8 See further: Reply, paragraphs 134 to 156.

9 Competition Commission, 'Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, Report', 4 August 2010 (**CC10**), and CMA, 'Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, Report', 6 October 2015 (**CMA15**).

- Ofwat also states in relation to customer support for uplifts to the cost of debt and cost of equity that "*the company now concludes that its evidence shows that customers were unconditionally content to fund its higher financing costs up to a bill impact of £3 per household per year*".[10] Our case is neither as narrow as this, nor described as unconditional. Section 6.2 of our Reply, and in particular paragraph 156, covers both this point and the wider research on the value customers placed on Bristol Water.

2.2 Company specific cost of debt issues – detailed points

11 In paragraph 2.5 of Ofwat's June BRL submission, Ofwat states:

> "*The company cites a premium for its 2011 bond over the iBoXX 'BBB' index of 75 basis points. Measured against the iBoxx A/BBB index actually used in our PR19 cost of debt benchmarks, we estimate a more modest spread of 21 basis points on the day of issuance. This would likely reduce further if the tenor of the bond (30 years) was closer to the iBoXX weighted average years to maturity of 21.6 years on the date of issue. The company's 10 year £25 million Sun Life term loan issued in 2018 carries a fixed nominal coupon of 2.61% - 70 basis points lower than the average iBoxx A/BBB yield for 2018 (3.31%).*"

12 This statement is inconsistent with the findings of Ofwat's own consultants, Europe Economics, who show that the spread of our 2011 bond against the iBoxx A/BBB index to be 91bps on the day of issuance (see line 47 of the 'All Bonds' sheet in Europe Economics' spreadsheet). As explained in our Reply,[11] KPMG's analysis finds a lower spread, albeit still a very significant spread of more than 75bps when measured against the relevant index (the bond was issued at a BBB rating, so the spread against the iBoxx A/BBB would be if anything, higher than this). Therefore, both Ofwat's consultants and KPMG's analysis show that the 2011 bond was issued at a significant premium to the iBoxx A/BBB index.

13 The difference in Ofwat's findings appears to be due to the analysis for the 2011 bond using different assumptions on long-term RPI inflation than that used by Europe Economics to convert the real yield on the 2011 debt to nominal for comparison purposes with the iBoxx index. Both the KPMG and Europe Economics analysis use market-based implied inflation, based on Bank of England data for this comparison. In contrast, Ofwat uses a long-term inflation assumption of 3%. The BoE inflation curve indicated a significantly higher inflation priced in yield curve data at the time.

14 It is not clear why Ofwat considers it appropriate to use inconsistent inflation data in this calculation compared to the calculation of the small company premium carried out by their consultants, Europe Economics. In any case, our view is that the implied inflation curve based on Bank of England data is a more appropriate, market-based measure of inflation at a particular point in time and for a particular tenor. We therefore consider that the measure presented by Europe Economics and KPMG of the premium paid on our 2011 bond better reflects the market view of the pricing of our 2011 debt than the alternative measure presented by Ofwat.

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10 Ofwat's June BRL submission, paragraph 2.18.
11 Reply, paragraphs 116 to 118.

15 Ofwat also attempt to present our more recent financing on the SunLife loan issued in 2018 as ‘cheap’ relative to the index. The comparison is misleading, and Ofwat are misrepresenting the facts by comparing quantities that are not comparable. In this case, Ofwat compares our SunLife loan, issued with a tenor of 10 years, with an index allowance which has around 21 year tenor. These quantities are not comparable, since in the current market conditions (where the yield curve has the ‘normal’ concave shape), the longer the tenor, the higher the yield. Therefore, the iBoxx A/BBB index should have a higher yield than our SunLife loan, given its longer tenor.

16 In paragraph 2.6 of Ofwat’s June BRL submission, Ofwat critiques the issues we raised in response to the new Europe Economics analysis that was annexed to Ofwat’s Response. We do not believe the responses raised by Ofwat change the arguments we set out in our Reply which expose the weaknesses in the Europe Economics analysis. Based on the assessment we have carried out, we believe that the KPMG analysis on which we based our estimates of CSA on embedded debt at 38bps remains reliable and a better assessment of the CSA for small companies than the analysis presented by Europe Economics.

17 Paragraph 2.6(a) of Ofwat’s June BRL submission states:

> “*The analysis does not control for credit rating: Bristol Water argues that the estimate of small company premium from the spread to benchmark gilt analysis could reflect credit rating differences between large and small companies rather than size. However, the company has not provided evidence showing that this looks to be a material issue – ie that credit ratings for larger companies have fallen faster or further than those for small water-only companies.*”

18 Credit rating is likely to be a material issue as we explain below (and in the KPMG SCP Report, submitted with our Statement of Case, section 4).

19 Ofwat’s argument that controlling for credit rating is immaterial is predicated on the assumption that both the WoC and WaSC have the same ‘average’ credit rating represented in the two samples so that any difference in average spreads of the samples has to be as a result of ‘size’. This might have been the case if the samples were otherwise homogeneous, i.e. (1) of the same size which in this case is important since the samples represent yield observations drawn through time under different market conditions / credit rating of the sector; (2) if the samples had the same concentration or profile of observations through the period of consideration, such that each sample would have similar ‘average’ credit rating, representative of the same ‘average’ deterioration of credit rating across the sector through time (on this, see KPMG SCP Report), and/or (3) if average credit rating was the same for both samples (even if profile of issuance was not) but spreads were constant through time, so that so long as the ‘average’ credit rating is the same across the samples, the average spreads would not be distorted by differences in the timing of issuance.

20 These conditions are very strong and do not hold in the samples of WoC vs WaSC debt available. Specifically, the WoC and WaSC samples are in fact different in size and include issuances concentrated in different time periods with different average credit rating for the industry as a whole. There is a lower number of observations in the WoC sample than the WaSC sample even before any filtering is done. To the extent that this might be accompanied with more concentrated credit rating around a particular point in time / credit rating in one sample than in the other (e.g. WoC issuance concentrated in the early 2000s where credit

rating of the sector was higher than today), it could result in significant bias in the sample, showing up as difference in the 'average' credit rating (relative to the WaSC sample). This would be further complicated if we consider that spreads to gilts are not constant through time.

21 Critically, a number of the bonds issued by water companies in the past were 'securitised' bonds, i.e. bonds with a credit rating significantly better than the iBoxx A/BBB index achieved through securitisation. Not only are these bonds not comparable to the allowance which is set at an average A/BBB rating, but to the extent that they represent a larger portion of either one of the samples of WoC vs WaSC debt, this would clearly create difference in the 'average' spread priced in the WoC vs WaSC sample. As a result, the analysis would then erroneously attribute to difference in size what is actually a difference in average credit rating across the samples.

22 For all of these reasons, it is clear that Europe Economics' failure to control for credit rating in its CSA analysis is a material flaw in its analysis, which should be rectified by the CMA.

23 Paragraph 2.6(b) of Ofwat's June BRL submission states:

> "*The analysis includes callable bonds in the large company sample and none in the small water-only company sample. Removing callable water and sewerage companies' bonds decreases the estimate of small company premium by 4 basis points; nonetheless for completeness we apply this change in our updated analysis for this submission.*"

24 This statement does not make sense, because callable bonds are more expensive than bullet bonds, all else equal. It is likely that this result is due to an interaction with the credit rating discussed above, or due to interactions with tenor or timing of issuance.[12] As there are no WoC callable bonds, this adjustment does not make the analysis Europe Economics / Ofwat have undertaken any more accurate.

25 Paragraph 2.6(c) of Ofwat's June BRL submission states:

> "*The analysis calculates spreads relative to a maximum 25 year gilt rate. The Bank of England yield curves used to calculate spread at issuance are generally limited to 25 years up to 2005, 30 years from 2005 to 2015, and 40 years from 2016 onwards. As a simplifying assumption we have compared yield of bonds with higher tenor with the yield at a longest maturity of the available curve. All other things equal, economic theory suggests that longer tenor should result in higher yield. Because small water-only company issuance has a higher average tenor (32 years versus 28 years for the rest of the sector), and is more concentrated in the early 2000s when yield curve data is more limited, this would seem to imply that increasing the tenor of reference gilt used in the comparison to match the tenor of instrument would, if anything, reduce the small water-only company spread to gilt at issuance. This would further reduce our estimate of the small company premium.*"

12 The Europe Economics analysis does not control for tenor and therefore includes spreads relative to gilt for bonds of various maturities including both long and short-term tenor. This might cause distortions if credit spreads in the samples vary with tenor. Where this is the case, the fact that the WoC vs WaSC samples might have different average tenor could further distort the analysis. Credit spreads could also vary with market conditions, which is not considered in this analysis.

26 We believe Ofwat's interpretation of their simplifying assumption to be incorrect. During the early 2000s, when significant part of Artesian debt was issued and when there was limited yield curve data available, the yield curve was in fact inverted. This means that instead of following a concave shape (the 'normal shape' expected in economic theory as referenced by Ofwat above), the yield curve in fact had a 'humped' shaped with rates falling the longer the tenor. All else equal, this means that the gilt rate that would have been subtracted to calculate spreads for the WoC bonds issued in the early 2000s, would be lower than the one used by Ofwat, which is based on shorter tenor as available. All else equal, the current analysis if anything understates the WoC premium.

27 Paragraph 2.6(d) of Ofwat's June BRL submission states:

> "*The analysis appears to selectively exclude Artesian III. Our review of the small water-only company instruments shows that the Artesian III instrument is incorporated, but is dated incorrectly. Applying corrections increases our estimate of the small company premium by 9 basis points.*"

28 Although Ofwat acknowledges the error in its response evidence which increases its new estimate from 5 to 14bps, it does not address the other concerns we set out in our Reply, or explain why its new approach should be used in preference to the other methodologies for calculating CSA which have regulatory precedent.

2.3 Cost allowances - leakage

29 In Ofwat's June BRL submission, Ofwat claims that Bristol Water raised new arguments and evidence in relation to the leakage claim (paragraphs 3.5 to 3.8 of Ofwat's June BRL submission). This is incorrect. The arguments set out in our Statement of Case and Reply are not new. In summary, the points we raised previously are:

- Ofwat's modelling changed throughout the price review process. Ofwat did not reveal the alternative model or PwC leakage analysis until the Final Determination. This explains the form of our submission to the CMA, rather than our previous submission to Ofwat as a potential company specific adjustment based on the Draft Determination.

- To assist the CMA, we refer to the Annex 3 of our Reply (Information on leakage innovation and efficiency), in which we summarise the key non-econometric modelling questions on leakage, such as how technological change contributes to our delivery.[13] We note Ofwat's submission does not refer to this annex or address the points raised. We believe it answers the points raised in paragraphs 3.5 to 3.8 of Ofwat's June BRL submission in full.

2.4 Developer services and enhancement efficiency

30 Ofwat asserts that we raised a new argument about the error in calculating the efficiency applied to developer services and enhancement efficiency (paragraphs 3.10 to 3.11 and 3.17 to 3.21 of Ofwat's June BRL submission).

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13 This evidence relates to Ofwat's statement on underexploited technological change in leakage reduction repeated in Ofwat's BRL June submission, paragraph 3.9.

31 This is not a new argument – it is a statement of fact. The efficiency factor applied to developer services and enhancement is not based on the base efficiency position in the FD. We do not disagree with Ofwat's description of the process it used,[14] but we consider Ofwat's approach and rationale is flawed and based on irrelevant considerations. The change in base efficiency modelling throughout the process, particularly to include growth expenditure helps to illustrate why this is the case.

32 As an illustration, Ofwat raises a new argument in Ofwat's June BRL submission that we did not reduce our enhancement costs to reflect Ofwat's estimate of the base efficiency position.[15] However, it is wholly unclear why Ofwat would expect us to reduce enhancement costs that were not in dispute (other than this additional base efficiency assessment), when Ofwat have not reviewed the case for that enhancement cost as they consider it to be of low materiality (i.e. shallow dive). Adjustments to efficiency (other than resilience where a view with Ofwat on the scope and related outcome incentives for the FD was reached that we have not disputed) and other enhancement adjustments were accepted by Ofwat after its April 2020 cut off for this "shallow dive" adjustment.

33 The focus of our case in this area is straight forward – we dispute that there is a base efficiency gap, but even if there was, Ofwat should have taken into account for both growth and shallow dive enhancement expenditure the efficiency we had applied to enhancement costs in our own plan (c. 9%).

2.5 Risk and return cross cutting issue – balance of risk and return

34 Ofwat's June BRL submission states that we raise a new argument that cost sharing rates should be amended in response to bad debt exposure due to Covid-19 company arguments for different cost sharing rates (paragraph 2.13).

35 This is not a new argument. It is merely an illustration of a point in our Statement of Case, using an example from an subsequent Ofwat intervention. For clarity, if the CMA accepts our argument on totex sharing rates, we assume Ofwat would apply it to this mechanism. We are happy to discuss any specific consequential problems this would cause Ofwat for this specific mechanism should the eventuality arise.

36 We note there are aspects of the regulatory determination that Ofwat does not apply company specific cost sharing rates linked to the PR19 efficiency judgements made by Ofwat (e.g. the strategic water resource schemes). Many water company respondents disagreed with Ofwat's use of the cost sharing rate for the Covid-19 circumstance, and Ofwat's response to this consultation does not provide evidence against the point we raise in our Statement of Case.

2.6 Use of Artesian financing

37 In Ofwat's Risk and Return further response,[16] Ofwat describes the use of Artesian issuance in 2004 as a means of financing a £51m return of capital to shareholders (as well as a £10m

14 Ofwat's BRL June submission, paragraph 3.19.
15 Ofwat's BRL June submission, paragraph 3.21.
16 Ofwat (June 2020), 'Reference of the PR19 final determinations: Risk and return – response to common issues in companies' 27 May submissions to the CMA', paragraphs 3.33 and 3.34.

special dividend). Ofwat then remove this 2015 borrowing from Bristol Water's total borrowings and reduce the interest costs accordingly (although no details of the calculation are provided). Ofwat then make an additional downwards adjustment to account for issuance proceeds being higher than the face value of the Artesian loans, using the 0.17% calculated by the CMA in the 2015 determination.

38 We note that Ofwat made the same argument in 2015 which the CMA considered and rejected.[17]

39 The CMA15 determination found that cash raised through debt is generally "*fungible, ie there is no obligation on Bristol Water to use particular funds for specified purposes.*"[18] The CMA then explicitly stated that whether cash was used for operational or other purposes was not the sole factor to be considered. However, given that Bristol and the other small companies at the time had difficulty issuing long-dated debt, and given that Artesian enabled small companies to do so, this issuance may have been optimal and therefore excluding it (as requested at the time by Ofwat) might be "*penalising Bristol Water for reasonable behaviour*".[19]

40 The CMA also noted that Bristol Water was only marginally above the notional gearing at the time, and so to the extent the non-operational financing increased costs, it considered it appropriate to remove Artesian debt only up to the point of notional gearing at the time. As a result, the CMA only removed £23m and not the entire value of the intercompany loan as Ofwat asserts should be done (as was the case in 2015).

41 Despite the lower gap to notional gearing that we have at PR19, we used in the same cross-check calculation of our actual cost of debt the same value that the CMA removed in 2015.[20] It is, however, arguable that a lower adjustment should be made (and not the methodology Ofwat now propose in this further submission). The CMA will also note that this methodology at PR19 suggests a 0.68% CSA debt uplift compared to the 0.38% included in our statement of case, informed by the KPMG CSA analysis.[21]

42 We also note the general observations made by Ofwat that other small companies, including those with Artesian debt (Affinity and South East) no longer receive a small company premium,[22] and that there are larger companies (e.g. Southern) with a higher cost of debt.[23]

43 We summarise the current Artesian debt in the table below:

- Nominal interest rate includes the accretion of ILD, cash interest rate is the cash interest paid (i.e. excluding accretion on ILD).
- Bristol Water and Portsmouth Water have a significant proportion of Artesian to total debt. However, Portsmouth Water receives a small company premium. Both companies have a similar cash interest cost of 3.5%. However, Portsmouth Water has a higher

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17 CMA15, Appendix 10.1, paragraph 35.
18 CMA15, Appendix 10, paragraph 35.
19 CMA15, Appendix 10.1, paragraphs 36 to 40.
20 Bristol Water Statement of Case, paragraph 225 (table B5).
21 KPMG SCP Report.
22 Ofwat's June BRL submission, paragraph 2.3.
23 Ofwat's June BRL submission, paragraph 2.5.

nominal interest cost which reflects that c.90% of its total debt is ILD (see figure below). In comparison, 50% of Bristol Water's debt is ILD.

- The proportion of Artesian debt relative to total debt is considerably lower for Southern and South East Water. South East Water also has a high proportion of ILD (80%).

- Bournemouth Water is now part of South West Water, so the share of Artesian debt is relatively small (4%). South West Water also had a low cost of debt relative to the sector prior to the merger.

Company	Dates Artesian issued	Total Artesian (£m)	Artesian debt (£m) incl. indexation	Total Debt, 2019 (£m)	Prop. of Artesian debt (2019)	Nominal interest rate, 2019 (%)	Cash interest rate. 2019	CSA received from Ofwat (PR19)	CSA received from Ofwat (PR14)
Bristol	2003 - 2005	£148.50	£197	£347	**57%**	**4.7%**	**3.4%**	No	No
Portsmouth	2002	£66.50	£108	£118	**91%**	**5.8%**	**3.5%**	Yes	Yes
Southern	2003 - 2004	£335	£520	£3,718	**14%**	**5.6%**	**3.4%**	No	No
Bournemouth (SWW)	2005	£65	£97	£2,392	**4%**	**2.6%**	**1.9%**	No	Yes (BW)
South East / Mid Kent	2002 - 2005	£169	£266	£1,084	**25%**	**5.9%**	**3.3%**	No	No
Dee Valley (Hafren / Severn T	2002	£35		*		*	*	No	No
South Staffordshire	2005	£128	£188	£269	**70%**	**6.0%**	**3.3%**	Yes	No

Source(s): Artesian I and Artesian II plc accounts, Annual Performance Reports – Table 1E, Ofwat PR19 Cost of capital appendix, p.95, Ofwat PR14 Policy Chapter A7 - risk and reward, p.43 Note: Proportion for Dee Valley difficult to calculate as Dee Valley was purchased by Severn Trent, and then split into Hafren.*

44 In conclusion, Bristol Water is the only small company not part of a larger group for which Artesian constitutes a significant part of the debt portfolio, that has not received a small company premium at PR19.

2.7 Risk and return cross cutting issue – financeability

45 Ofwat raises a general cross-cutting topic concerning in the June letter:

> *"New company challenges to prior PwC argument that use of RCV run-off and PAYG does not adversely impact long-term financeability. New company evidence on financeability impacts of downside scenarios. We supply new evidence on changes to Moody's assessment methodology since our determination, and responses to above issues raised by companies."*

46 We consider Ofwat's statements about Moody's rating to be speculative in nature. We address Moody's statements about its ratings considerations in section 14 of our Reply.

47 Annex 4 of our Reply summarised for the CMA the evidence on the role and financeability impact of the different types of scenario testing. Our previous observations on the downside scenario testing were that Ofwat took a very different perspective during the price review process, 'naming and shaming' companies including Bristol Water because of the downside risk scenarios.[24] In our case, it was always clear that the CSA debt uplift, cost allowances and sufficient cost of equity were the key determining factors in the different scenarios. We note Ofwat do not refer to Annex 4 of our Reply in its June submission.

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[24] Ofwat (2019), 'PR19 draft determinations Aligning risk and return technical appendix', page 70.

3. Other issues raised in Ofwat's June 2020 submission

48 We are uncertain as to the status of the sections of Ofwat's June submission that are not referred to in the June letter. However, to assist the CMA there are two areas raised by Ofwat in its June submission where we provide some limited comments.

3.1 Cost efficiency issues

49 In paragraphs 3.3 and 3.4 of Ofwat's June BRL submission, Ofwat states that we have not presented any evidence to support our statement that that the update models from NERA and Oxera (using data after 2016/17) show Bristol Water to be efficient.

50 In our Reply we explained that Ofwat's view that most of NERA's and Oxera's cost models were in line with Ofwat's models was not relevant, as this crucially related to BW's cost base before 2016/17.[25]

51 In Ofwat's June BRL submission, Ofwat states that it does not consider its view to be misleading as these models were used by Bristol Water to inform its business plan. Ofwat references a table (Table 3-12 in BW's business plan, section C5). That table clearly shows a view of historical inefficiency (2014-17) and an up-to-date view at the point of the business plan submission (2016/17). The up to date view was a 1% efficiency gap to the industry upper quartile.

52 Our cost allowance case explores the range of reasons why the further challenge to efficiency beyond the stretching targets in our plan reflect a narrow application by Ofwat of a cost modelling process, rather than considering the evidence in the round. These base efficiency models, compared to the level of cost in our Statement of Case, provide an indication of our proposed costs being beyond an efficient benchmark level. Ofwat's statements in this further submission do not address this point.

53 In paragraphs 3.15 and 3.16 of Ofwat's June BRL submission, Ofwat suggests with reference to the C&RT cost adjustment claim that we have calculated the number of sources incorrectly and this is not consistent with Ofwat's Regulatory Accounting Guidance.

54 Ofwat undertook a series of discussions and early submissions on water resource allocation to ensure in advance of the PR19 cost modelling and the allocation Ofwat referred to was specifically agreed as part of this process. The conclusion of this discussion was that because the canal was acting as a reservoir to the treatment works, the abstraction for Purton and Littleton involved five sources. We have the correspondence with Ofwat available for submission, but we have not included it here as we believe this topic is not central to the cost adjustment claim and has not being highlighted by Ofwat as a key issue. Nevertheless, we can provide this additional evidence if the CMA believe it is helpful.

3.2 Mains burst performance

55 In paragraph 4.10 of Ofwat's June BRL submission, Ofwat asserts that Bristol Water failed to meet the mains burst performance target over 2016-19. For clarity, Ofwat's statement applies

25 Reply, paragraph 219.

to the reference level, however only in one year (2017/18) did the level of mains bursts exceed the serviceability upper control limit, which was the performance commitment for the 2015-20 period. Although adverse weather affected 2017/18 and 2018/19 mains burst performance, this emphasises the risks customers saw in penalties applying to adverse weather. As an illustration for the CMA, 2019/20 performance is below the reference level of 950 bursts at 798 bursts. This performance is in part supported by benign weather.

56 The CMA has heard directly from the Bristol Water Challenge Panel on the specific topic of customer views' on mains burst incentives.

57 We note that Ofwat states in the further information specific to Anglian Water that in relation to Ofwat's use of comparative ODI rates that "*The onus is on companies to validate the results of their customer engagement*".[26] This renders engagement with customers to help develop a business plan to a subsidiary position, given that insufficient time could be allowed by Ofwat for redeveloping a plan with customers once it has been developed. We note the helpful third party submissions the CMA have received concerning the impact this has on the regulatory framework, notably from Stephen Littlechild.[27]

[26] Ofwat (June 2020), 'Reference of the PR19 final determinations: Response to Anglian Water's 27 May submission to the CMA', page 24.

[27] Submission from Professor Stephen Littlechild to the CMA on Ofwat price determinations, 24 May 2020. Available at: https://assets.publishing.service.gov.uk/media/5eda3e6ce90e071b7bd7a2ed/Stephen_Littlechild_submission.pdf.