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Annex 1: Clarifications following Bristol Water's hearing of 29 July 2020

Upon reviewing the transcript, we agreed to provide further information on a limited number of topics. Having reviewed the Ofwat hearing transcripts, we consider there are a few areas where there would be a benefit from us providing further brief clarification of our position.

These topics are:

- The overall position on the cost allowance
- The cost-service relationship
- Growth cost allowance
- Cost of debt
- Inconsistency of the Europe Economics (EE) analysis on the CSA
- Intercompany loans and the calculation of the cost of debt

1. Overall position on the cost allowance

Our cost allowance request is not a sum of the individual topics we discussed at our hearing. To summarise briefly; our business plan was developed using a wide range of evidence, including bottom-up and top-down assessments. This gives us confidence that our overall cost position is efficient and robust.

In Section C of our Statement of Case we outlined a number of errors within Ofwat's approach which each led to an underestimation of our efficient cost base. The sum of the individual errors is £38 million to £51 million, which is greater than the gap of approximately £30 million between our position in our final Business Plan and Ofwat's Final Determination. Section 20 of our Statement of Case (paragraphs 589 to 592) provides a summary of how our proposed remedy is less than the sum of the individual quantification of errors based on Ofwat's cost assessment framework. This granular approach supports our position that Ofwat has underestimated our efficient costs, and that our business plan is the more robust of the two positions.

Section 20 of our Statement of Case provides a summary of how our proposed remedy is less than the sum of the individual quantification of errors based on Ofwat's cost assessment framework. We clarify the key areas discussed at our hearing below.

2. Cost-service relationship

Upon reviewing the transcript, we thought it helpful to summarise the issues surrounding the cost-service relationship. Our position is as follows:

- There is no structural link in Ofwat's methodology between costs and service.

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- Higher service levels cost more than lower service levels.[1]
- Because companies are operating at different levels of service, Ofwat is not comparing like-for-like when benchmarking base costs.
- Bristol Water is a relatively high performing company, and so comparing our costs to lower performing companies leads to our base costs being underestimated.

In our Statement of Case,[2] we estimate the scale of this issue by reviewing where Ofwat had made explicit enhancement cost allowances for other companies. Where such allowances were made to help enable other companies catch up to our levels of service, we adjusted those companies' historical base costs – i.e. simulating a situation where companies had incurred these costs in the past to help improve comparability to our base costs.

In the hearing, the CMA Panel queried whether our approach was a one-way adjustment – i.e. that we had only adjusted for where we are delivering higher levels of service, rather than considering all measures of service.[3]

First, there are only a few areas where Bristol Water is a below average performer. In terms of key measures, the only area where we could be considered as below average historically is supply interruptions, where our performance was volatile over the last few years. Our performance was around average in 2019/20. This is a single measure which is subject to one-off incidents, including those caused by third parties. Given the low amounts of expenditure that companies have proposed to improve supply interruption performance, this is clearly not a particularly material area when compared to the other cost categories considered.

Second, we recognise that there is an element of subjectivity in carrying out this analysis, therefore we tested the sensitivity by reducing the amount of costs we adjusted – we found that this still results in a material estimate of the extent of the issue. Appendix 2 of the KPMG Cost Model Review Report, which was submitted with our Statement of Case, provides details of the sensitivity analysis.

3. Growth cost allowance

In the hearing, we agreed to articulate the growth base cost adjustment in writing for clarity.[4]

In the FD, Ofwat erroneously underestimated our efficient growth costs by £4.1m. This figure is calculated using the following two factors:

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1 Notwithstanding Ofwat's approach in PR19, it is a widely accepted that there is usually a cost associated with a service improvement. Indeed, if improving service was costless then it is expected that companies would have improved service levels in AMP6 up to the outperformance caps in order to benefit from the AMP6 ODI rewards. With very few exceptions, this has not happened. Further, Ofwat explicitly made an allowance for costs in relation to service areas. where other companies are needing to catch up to BW – these are the basis of our analysis (see section 10 of our Statement of Case). We also note that companies spent £1.5bn more than the PR14 allowance, of which £0.9m in 2019/20. Logic suggests this includes the cost of higher service levels, in particular leakage.

2 Statement of Case, paragraphs 357 to 368.

3 Transcript, page 31, line 18, to page 32, line 4.

4 Transcript, page 89, line 13.

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- The difference in the assumed growth rates applied to the modelling – Ofwat uses a lower ONS estimate than our WRMP estimate.

- A higher unit cost allowance – Ofwat erroneously applies a 12% efficiency factor to the unit cost.[5]

Each of these factors are detailed below.

Graph C3 in our Statement of Case[6] shows the stark difference between Ofwat's forecast based on ONS data and our own forecast. We estimate that there will be over 5,000 more new properties built in our supply area during AMP7 than is estimated by ONS. This is more than 20% greater than the ONS forecast. Our estimate was based on detailed work with the relevant local councils and is the basis of our WRMP assumptions.

Such a significant understatement of possible growth by Ofwat is important as it creates a material cash-flow impact on the company owing to the need to meet the costs when they are incurred (while the true-up will be at the end of AMP7). This includes the offsite network reinforcement costs (which are around 40% of the costs), which have to be incurred in advance of new properties connecting.

Additionally, this issue is exacerbated due to Ofwat's erroneous application of the efficiency challenge, which results in the allowed unit cost being too low and, as such, an under-recovery of costs.

The issue with respect to the efficiency factor is best explained in our reply to Ofwat's response to our Statement of Case. Paragraphs 301 to 304 outline the explanation as to why Ofwat has erroneously calculated and applied an efficiency challenge to our growth enhancement costs.

To summarise briefly:

- We have already applied a stretching efficiency challenge to our enhancement costs, prior to any proposals from Ofwat. Therefore, we do not consider that any further challenge is appropriate.

- The challenge that Ofwat has applied is based on its original estimated historical efficiency gap derived at the IAP. It does not allow for the fact that costs were further refined following DD. It includes an adjustment of £4m assuming a reallocation from enhancement to base spend for resilience schemes which has no justification. If further challenge were to be appropriate, then it ought to be based on the latest assessment of our cost efficiency, which would lead to a significantly smaller value than that applied by Ofwat.

These factors when combined lead to a £4.1m shortfall in the gross growth cost allowance.

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5 See Ofwat (2019) 'PR19 final determinations: Our approach to regulating developer services', Table A3.

6 Statement of Case, page 119.

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So, while Ofwat's DSRA mechanism will provide some additional revenue for Bristol Water at the end of the control period (due to the fact Ofwat's forecast of growth volumes is too low), it will not entirely remedy the issue due to the erroneous unit cost challenge that Ofwat applies to the true-up factor.

4. Cost of debt

At the hearing, Mr Muysert referred to a comparison between a 10-year facility with a 10-year iBoxx A/BBB rate.[7]

We understand that this refers to Ofwat's assertion that Bristol Water's Sun Life 10-year facility has a lower cost relative to the iBoxx 10+ A /BBB index, which Ofwat used to set the cost of debt allowance.[8]

We would like to further clarify that, as acknowledged by Ofwat,[9] the iBoxx 10+ allowance actually has a tenor of close to 20 years. Therefore, the comparison of the 10-year Sun Life loan (and other recent loans issued by Bristol Water) to the iBoxx 10+ index is inappropriate, as the loan and index include different term premia. This point was made by our advisors KPMG at the hearing on 29 July 2020,[10] but we thought it was helpful to further clarify this point in writing.

5. Ofwat's response in relation to the inconsistency of the Europe Economics (EE) analysis on the CSA and their PR19 FD

At its hearing on 22 July 2020, Ofwat was asked a question[11] regarding the inconsistency between the 33bps CSA in its FD and the 5bps allowance in its June 2020 'Response to Bristol'.[12] Ofwat's response at the hearing included the following points:

- The 33bps was based on spreads to iBoxx analysis which does not control for tenor. The estimates were based on a premium to iBoxx for WoCs plus a 'halo' effect (or discount to iBoxx) for the WaSCs.

- The subsequent analysis by their consultants, EE, was based on a 'spread to gilt' method that controls for tenor. This analysis was used to support a 5bps CSA. It was subsequently revised to 10bps to address one of the errors in the analysis pointed out by Bristol Water.

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7 Transcript, page 29, lines 2 – 4.

8 See Ofwat's Response to Bristol Water's 27 May submission to the CMA, June 2020, paragraph 2.5, second bullet. Ofwat compares the cost of the 10-year Sun Life loan to the average value of the iBoxx 10+A /BBB index in 2018, the year when the loan was issued.

9 *Ibid.*.

10 Transcript, page 31, lines 9 – 16.

11 Ofwat transcript of hearing on 22 June 2020, page 62, lines 10 – 16.

12 Mr Muysert refers to Ofwat's Response to Bristol Water's 27 May submission to the CMA, June 2020, paragraph 2.4. For completeness, we note that the 5 bps allowance was first identified in Ofwat's May 2020 Response (Response to Bristol Water's Statement of Case, Document 003, paragraph 6.50) and was subsequently adjusted to 10 bps (Ofwat's June 2020 Response to Bristol Water's 27 May submission, paragraph 2.7).

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- Ofwat then argued that the former analysis is less appropriate than the latter, because the former is based on an assessment that does not control for tenor. Ofwat therefore appear to be rejecting its own determination of the CSA in the FD as less appropriate than its new analysis, which is based on the 'spread to gilts' method.

We note the following in relation to these points:

While the 'spread to gilts analysis' presented by EE does control for tenor, critically it does not control for credit rating. This means that the analysis will ascribe to 'size' what are actually differences due to:

- average credit rating being different in the two samples, which in this case could be significant as much of the small WoC debt is concentrated in the early 2000s, i.e. at a point in time when the average rating in the industry was significantly better (see KPMG SCP Report, Figure 6); This could understate the premium if the average credit rating for WoCs is higher than the average credit rating for WaSCs debt; and

- timing of issuance differing across the samples, which means that the two samples would be capturing different macroeconomic conditions, and therefore reflecting different average levels of credit spreads (the spread to gilts method does not control for credit spreads varying with macroeconomic conditions).

As explained above, and in greater detail in our July Reply,[13] the failure to control for credit rating is likely to significantly distort the analysis as it would attribute to 'size' what are in fact differences in other factors that affect bond pricing, specifically time-varying differences in credit risk.

As explained in the KPMG SCP Report (section 4), in order to isolate the impact from size on debt pricing, there are three key factors which need to be controlled for when estimating the CSA – timing of issuance, tenor and credit rating. The KPMG analysis controls for all of these factors and finds a CSA premium of 30 – 47bps.[14]

Separately, we also note that the CMA's own analysis in 2015 partly controlled for all of these factors, including for credit rating through the use of the 'spread to iBoxx' approach, and for tenor through the exclusion of short-term debt. On this basis, the CMA concluded that 40bps remains to be an appropriate estimate of the CSA.

Ofwat's current proposed method is a departure from that precedent, and is an inferior measure of the premium because it fails to control for key aspect of bond pricing.

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13 Reply to Ofwat's further submission, July 2020, paragraphs 17 – 22.
14 KPMG SCP Report, paragraph 4.6.1.

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As further explained in our July Reply,[15] there are other deficiencies in the EE 'spread to gilt' analysis, including that:

- The analysis includes callable bonds in the WaSC sample. These are more expensive than bullet bonds and therefore, all else being equal, artificially increase WaSC yields.

- The analysis is also subject to data limitations (e.g. gilt yields not being available beyond 25 years), which further distorts the results.

Finally, it is worth noting that in addition to the differences in yields between WaSC and WoC bonds, there are other non-yield related costs that contribute to there being a small company premium, including, for example, the cost of carry.

For all of these reasons, our view is that the EE analysis cannot be used as an indication of what should be the appropriate size premium for Bristol Water's notional small company cost of debt.

We also note that Ofwat's current position appears to be that the 'spreads to gilt' method is an appropriate measure of the CSA for Bristol Water, despite it being inconsistent with its own estimate at FD, and despite it providing a significantly different value for the CSA than alternative methods. We remain concerned about the risk associated with the introduction of this new analysis from Ofwat that is so far removed from its position during PR19, and then not to see our challenges addressed by the regulator (with the exception of one of the errors we identified).

6. **Intercompany loans and the calculation of cost of debt**

At its hearing on 22 July 2020, Ofwat suggested that the full portion of the intercompany loans should be removed for the purpose of calculating the allowed cost of debt for companies that have increased gearing and used cash proceeds to return capital to shareholder via intercompany loans.[16] In Ofwat's terminology, 'non-operational financing' should not be paid for by customers.

In relation to this, we would like to highlight to the CMA the following three points.

First, Ofwat made the same argument before the CMA in the PR14 redetermination. The CMA considered this point in detail in Appendix 10.1 of its decision.[17] The CMA opined that debt is "*fungible*" and that companies are at liberty to use cash for operational and non-operational purposes. The CMA then reasoned that if there were a case for adjusting for non-operational financing, this would only be done up to the point of notional gearing (i.e. not removing the full amount of the intercompany loan as suggested by Ofwat). The CMA then calculated Bristol Water's cost of debt based on two scenarios:

- a scenario where no adjustment is made for intercompany loans on grounds that the company was at liberty to use those finds for non-operational purposes; and

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15 Reply to Ofwat's further submission, July 2020, paragraphs 23 – 26.

16 Ofwat transcript of hearing on 22 June 2020, page 49.

17 CMA (2015), 'Bristol Water plc: A reference under section 12(3)(a) of the WIA91 – Report', Appendix 10.1, paragraphs 36 – 40.

- a scenario where an adjustment to the cost of debt was made through removing debt only to the point necessary to reach the target notional gearing.

Precedent from the CMA therefore does not support Ofwat's approach to removing any debt that was raised at a time that coincides with capital restructuring where returns are made to shareholders. This is further explained in our July Reply.[18]

Second, although Ofwat puts Bristol in the same bucket as other appellants, the gap to the allowance presented in our Statement of Case already accounts for the adjustments for the intercompany loan, as made by the CMA. Even where these adjustments are made, we still find a gap of 68 basis points to the allowance, which is higher than our requested CSA adjustment of 38bps.

Third, our gearing cannot be considered high. For 2019/20, it is 66% (excluding preference shares), with the listed companies Ofwat uses for notional comparisons at 65%-68%.

18 Reply to Ofwat's further submission, July 2020, paragraphs 38 – 41.

Annex 2: Cross-reference for material points raised in the transcripts of Ofwat's hearings of 15 and 22 July 2020

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
First Ofwat hearing (15 July)			
20.19 – 22.23	In the context of a discussion on leakage, Robin Cohen enquired about Ofwat's commissioning of PwC to run additional analysis. Ofwat responded that it had tested leakage as a service variable and did not find a robust relationship. When Ofwat looked at it again, it found that the statistical significance was not very strong.	It is not clear on what basis Ofwat reaches this conclusion. PwC's report considered different measures for leakage. In each of the chosen models, the leakage explanatory variables prove to be statistically significant. In fact, the TV5 and TV6 alternative models used by Ofwat to check the chosen base models for the FD incorporate elements of some of these model specifications. The significance varies by approach – some are beyond the 1% significance threshold. Further, the R^2 values for these models are higher than for the Ofwat chosen base models. All this makes the "*not very strong*" comment from Ofwat difficult to understand. What is clear is that leakage is a key explanatory variable for the industry (albeit that Thames Water is different, hence the need to allow for a Thames Water dummy).	SoC, paragraphs 370 – 395
75.18 – 77.07	[✂] observes that Ofwat tested the levels of penalties and made adjustments "*to make sure that the incentives and the risk on leakage dominated mains repairs because leakage is more important to customers than mains repairs*". [✂] notes that "*the package is designed taking those variations [in weather] into account and that they will even out to some extent over a five year period*".	We agree with the approach as described by Ofwat in principle. However, the issue is that the FD package is not balanced. Ofwat's own analysis (figure 2.1 of 'PR19 final determinations: Bristol Water final determination') shows our incentive package to be dominated by mains repairs and per capita consumption. We previously raised weather impacts during our hearing and we illustrated the impact on penalties as part of the evidence we presented for the limited ODI adjustments we propose.	SoC, paragraphs 621 – 625 SoC, Annex 9
77.08 – 77.10	[✂] notes "*Waterwise have made submissions – in their view, the penalties are not sufficient*	This is a generalisation that does not apply to Bristol Water. It is clear from Waterwise's submission to the CMA that its concerns regarding sufficiency of penalties	Letter from Helen Hancock to Kip Meek dated 22 June

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
	to hold companies to deliver on their water efficiency programmes”.	do not apply to Bristol Water (see Waterwise submission to the CMA, page 6).	2020, responding to Ofwat’s Issues Paper
90.20 – 91.06	[✂] discusses adjustments to individual companies’ PCs and notes that they are “*set on a level that reflects the company’s history of service performance as well as the comparative challenge*”. Anne Fletcher then queried the relationship between BW’s P90:P10 leakage and the P50 target.	The levels of leakage P10 and P90 forecasts are credible and are not something that Ofwat specifically challenged during PR19. Although not central to the case we put forward, we set out an explanation below, after this table.	**Note 1**
124.13 – 124.19	[✂] states *“Yes. We applied a proportionate approach here. There is a lot of low-materiality proposals that are presented to us. We thought it was reasonable to assume that the efficiency that we observe on base costs is our best proxy to the efficiency of the business plan as a whole. I understand that this is an assumption that is not always going to be true, but we did observe, for example, in the case of Anglian, as we already noted, they were inefficient across base and enhancement.”*	This generalised assumption does not appear to hold true for Bristol Water. Ofwat did not appear to apply this approach to us as it did not update its efficiency challenge to reflect our response to the DD. On enhancement costs, where Ofwat did assess efficiency, we were found to be efficient.	Reply, paragraphs 301 – 304
133.09 – 133.20	[✂] notes that there were opportunities for companies to engage and discuss their proposals during the PR19 process.	This does not reflect our experience. As we stated at the hearing, we tried to engage with Ofwat on Bristol Water specific topics and some of the broader questions the panel is considering. Ofwat did not feel able to engage, which was their decision but, as we can show, this was not because of the any failure on our part.	BW Transcript, 12.22 – 13.07 **Note 2**
134.06 – 134.08	[✂] observes that “*what distinguishes the companies that are disputing the determination is in fact their failure to shift during the process*”.	This is a generalisation that does not apply to Bristol Water, given the previous Ofwat submissions. We did shift our position during the PR19 process to the extent we could. Indeed, Ofwat noted that we had “*resolved a number of issues*” in our revised April 2019 business plan (Ofwat Response to Bristol Water’s SoC, 003, paragraph 2.21).	

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
		We also note the statement on page 38 of the Third Ofwat teach-in session at the start of this process: *"We consider that the company has challenged itself significantly on costs during this current price review"*. We would also highlight Ofwat's comment in our FD: *"Our decision to make the partial allowance is also because we acknowledge that the company challenges its own costs considerably throughout the price review process, including submitting costs lower than its historical costs in its business plan, and revising it further during the review"* (Ofwat, Bristol Water FD, page 36).	
140.14 – 140.15	[✂] notes that "*we think companies have, if you like, misrepresented the supposed tension [between resilience and affordability] in terms of their representations*".	This is a generalisation that does not apply to Bristol Water. We have not presented our case in this way. The distinguishing features we have presented to the CMA are: (a) Bristol Water was one of the two companies that proposed totex costs lower than the comparable historic period; and (b) the research that drove our plan cost efficiency, outcome and incentive balance is covered in the Ofwat transcript referenced at page 61 and 69 above.	SoC, Annex 7, paragraph 5. BW Transcript, 45.12 and 135.12
Second Ofwat hearing (22 July)			
36.11 – 37.15	[✂] states that the gearing outperformance sharing mechanism "*does not apply below 70 per cent gearing*". [✂] also states: "*So, I think yes, intervention, we would characterise, as quite modest, proportionate, affects only five companies in the sector. So, I think any sort of attempt to read this across in sort of a wider approach somehow rather goes well beyond what we sent out in the statement.*"	We consider the reference to 70% gearing omits a material point. Whilst the mechanism is triggered once gearing exceeds 70% (by 2025), if triggered the calculation of the penalty applies for all debt above 65%. This is a key concern as even if the proposition was that there is a limit to gearing beyond which the risk requires this mechanism and such that it only affects five companies in the sector, the design of the Ofwat mechanism fails to adjust for this. Based on 2019/20 accounts, we observe eight companies with gearing above 70% and 14 above 65%.	SoC, paragraph 669 and 697

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
44.17 – 44.24	[✂] justifies the use of a notional structure as it is in line with regulatory precedent and "*consistency is important here*".	We agree that regulatory precedent and consistency is important. However, Ofwat does not apply this consistently. Ofwat considers that it is well-established that it should consider the notional company when estimating the cost of debt. However, Ofwat refers to what it considers to be Bristol Water's actual debt as part of its justification for refusing to allow a CSA. Regulatory precedent includes allowances for CSA debt and equity, which is part of regulatory precedent that a notional structure has to be relevant to the characteristics of the company.	Reply, paragraphs 64 and 79
58.07 – 58.09	[✂] notes that it is difficult to engage with customers about the benefits of a merger.	It is not clear on what basis Ofwat reaches this conclusion. Bristol Water sought customers' views on a hypothetical merger.	SoC, paragraphs 177 – 178
63.24 – 63.25	[✂] states that "*the spread to iBoxx method does not control for tenor*".	The EE method of calculating iBoxx spreads does not control for tenor, however, other implementations of this method do control for tenor. For example, as set out in our SoC, the way we implement spread to iBoxx does control for tenor. Equally, CMA 2015 considered only long-term bonds when implementing this method. The general statement that the iBoxx method does not control for credit rating is therefore incorrect.	SoC, paragraph 213 KPMG SCP Report, paragraph 4.3.1.3 Reply, paragraph 76
65.14 – 65.16	[✂] states that he is concerned that "*a focus on this concept of ex-ante efficiency incentivises companies to come up with a good story, rather than focussing on this outcome that matters to customers*".	This is incorrect as debt pricing is always *ex ante*. This response implies that companies have a choice about whether, *ex ante*, to outperform the market, whereas they do not have foresight into how the cost of debt will evolve.	Reply, paragraph 109
65.17 – 65.20	[✂] states that several companies, including Bristol Water, "*outperformed the allowance at the time by significant margins*".	We have submitted detailed evidence setting out why Ofwat's view on historic outperformance is flawed.	Reply, paragraphs 98 – 105
69.23 – 70.06	[✂] states that Bristol Water has been able to raise finance that outperforms iBoxx by 70bps	This is incorrect. As set out in our Reply, the 2011 bond was issued at a significant premium to iBoxx. The SunLife loan was indeed lower yield than the iBoxx 10+ , but as	Reply, paragraphs 116 – 118

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
	and that Bristol Water now has more options to raise finance than was available historically.	set out in detail in Annex 1 and in our hearing, this is an 'apples to pears' comparison as the iBoxx 10+ has 20Y tenor vs the Bristol SunLife loan had a 10Y tenor. Ofwat has not responded to our critique of their analysis.	BW Transcript, 31.11 – 31.16 Annex 1 to this submission, section 4
70.18 – 70.23	[✂] states that Bristol Water "*gave up*" on seeking a cost of equity CSA and "*put [it] on the table again at appeal*".	This is incorrect. Bristol Water did not "give up" on the cost of equity CSA in the run up to PR19.	Reply, paragraphs 134 – 140 BW Transcript, 33.14 – 35.09
75.05 – 75.14	[✂] notes that Ofwat undertook a financeability assessment for each company on a notional basis that included a headroom check against an adjusted interest cover of 1.0 times.	This is incorrect. It is a key part of our SoC that Ofwat failed to undertake an adequate financeability assessment, and in particular what we describe as the "headroom debt service test". In its Response (Ofwat 008, Risk and return – response to common issues, paragraphs 4.82 – 4.89), Ofwat described how this is an actual financing assessment, and the weak Bristol Water headroom is explained by past performance adjustments. Ofwat contradicted this explanation in their hearing and their description of this issue is consistent with our SoC. Our challenge to Ofwat as to how this notional financeability assessment has met Ofwat's own test, albeit an inadequate test in our view, has remained unanswered.	SoC paragraph 67 Reply, paragraph 412 and Annex 4
140.04 – 140.11	Anne Fletcher asked Ofwat how to approach the CRT arbitration. [✂] noted that "*On the basis of the information in front of us, I would suggest you retain the position that Bristol Water set out in its business plan*".	As Ofwat stated, our proposal for a 75% sharing rate is in line with regulatory precedent and as a Notified Item requires us to make every effort to minimise costs to customers. Whether there was a 75% or 100% sharing rate, the cost sharing still allows Ofwat to judge that we have not managed the cost risk reasonably. 100% cost pass through would go beyond regulatory precedent and the reasons for doing this would need to be exceptional in our view, with no alternative from a financeability perspective. For that reason, our preference remains to consider our plan as a whole and retain the 75% , noting this included the regulatory precedent for recognising	N/A

<table>
<tr><th>Ofwat Transcript Reference (Page.Line)</th><th>Issue</th><th>Bristol Water comment</th><th>Reference to previous Bristol Water submissions</th></tr>
<tr><td></td><td></td><td>that the current C&RT cost are a valid adjustment to the base cost models, and that our financeability headroom is supported by CSA allowances.</td><td></td></tr>
<tr><td>154.01 – 154.02</td><td>[✂] states that “Companies are earning about 25 per cent more than the allowed return on equity at both PR14 and PR09, so there is consistent outperformance on that”.</td><td>Ofwat’s analysis is materially skewed by the inclusion of listed companies. Based on 2019/20 data for the PR14 period in total (AMP6), we calculate the outperformance is 17%. When you exclude the three listed/enhanced/fast track companies, there is 2% underperformance. For water-only companies, the outperformance is 0.7%, although only one company outperforms. This data is subject to Ofwat 2019/20 data scrutiny and queries.

<table>
<tr><th></th><th>AMP6 RORE</th><th>Outperformance (%)</th></tr>
<tr><td>Total Industry</td><td>6.6%</td><td>16.6%</td></tr>
<tr><td>Excluding listed</td><td>5.5%</td><td>-2.0%</td></tr>
<tr><td>Water only companies</td><td>5.7%</td><td>0.7%</td></tr>
<tr><td>Ofwat PR14</td><td>5.7%</td><td></td></tr>
</table></td><td>BW Transcript, 20.21</td></tr>
<tr><td>154.10 – 155.02</td><td>[✂] quotes several Environment Agency sources that state that water companies are underperforming.</td><td>These quotes do not apply to Bristol Water. The Environment Agency has not historically included water only companies within their annual Environmental Performance Assessment. Therefore, the quotes are not on an assessment of Bristol Water performance, rather is limited to referring to <u>the water and sewerage companies only</u> as the water sector. The EA make this distinction very clear in the introduction to their report: https://www.gov.uk/government/publications/water-and-sewerage-companies-in-england-environmental-performance-report/summary-environmental-performance-of-the-water-and-sewerage-companies-in-2018.</td><td>N/A</td></tr>
<tr><td>161.01 – 161.08</td><td>[✂] states that he is reassured that all four disputing companies are raising “quite different issues” and that “there is not really a commonality of complaints”. He describes</td><td>This is a highly reductive view of Bristol Water’s case and is therefore incorrect. The cost of capital and CSA is one concern we raise. However, financeability constraints</td><td>SoC, Executive Summary, paragraphs 6 - 8

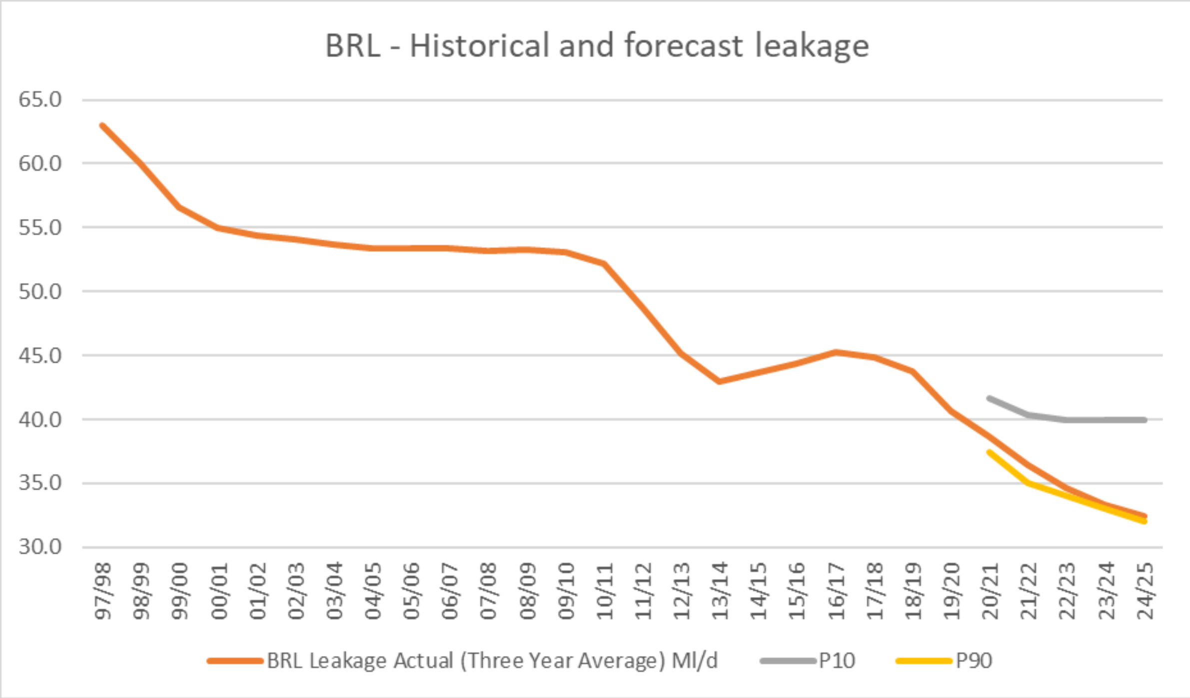
BW Transcript, 11.03 – 11.13</td></tr>
</table>

Ofwat Transcript Reference (Page.Line)	Issue	Bristol Water comment	Reference to previous Bristol Water submissions
	Bristol Water's complaint as being "*a small company financing issue*".	also arise from the cost allowances and balance of risk and reward.	
168.25 – 169.10	[✂] concludes with three points. The first is to query why each of the four disputing companies are "*not able to rise to the level of stretch on performance and efficiency in our final determinations*". She then notes that leakage has been improved without the need for extra funding.	This generalisation does not apply to Bristol Water as our issue is not with stretch on performance. Ofwat accept up to the FD that our plan was both stretching and ambitious. Rather, it is the way the efficiency assessment is not reasonable on base costs. It is incorrect to say that leakage has been improved without the need for extra costs, as set out in our SoC.	SoC, paragraphs 385 – 390
169.11 – 169.13	[✂] second point is to ask why companies cannot finance their businesses from the PR19 WACC when market evidence shows financing costs are falling and the listed companies are already trading at a premium to RCV.	This generalisation does not apply to Bristol Water. The fact that market evidence shows that financing costs are falling is not an adequate response to our financeability constraints. We have set out in detail our concerns with Ofwat's approach to the cost of capital in the SoC, Reply and reports by KPMG and Economic Insight.	SoC, sections 7 and 8 Reply, section A
169.14 – 169.21	Finally, [✂] asks what has made it so difficult for these four companies to amass the evidence to justify the enhancement schemes in dispute, even after several rounds of discussions with Ofwat and detailed feedback.	This generalisation does not apply to Bristol Water. Our enhancement schemes are not in dispute.	N/A

NOTE 1: Bristol Water Leakage P10 / P90 levels

At the Ofwat first hearing (page 90) Anne Fletcher uses Bristol Water P10:P90 leakage range as something that does not seem plausible compared to the P50 target. It was not clear whether this referred to Bristol Water assumptions or separate Ofwat analysis, although we are not aware of any Ofwat challenge to this. We felt it would be helpful to explain why the target and P10:P90 ranges are plausible.

The graph below shows the three-year average for leakage historically and the P10, P50 and P90 2020-25 estimates and targets.



It is important not to compare leakage P10/P90 levels in the September 2018 or April 2019 business plan to the subsequent submissions. The adoption of the more consistent leakage measure mandated by Ofwat (which resulted in the 15% reduction in our WRMP for 6.5Ml/d reduction increasing to 21.6% in the FD for the same 6.5Ml.d 2020-25 reduction) affects the P10 and P90 levels and this is only a statistical measurement change. The graph above shows data consistent with the FD measurement of leakage. We note that in Ofwat's most recent submissions (e.g. post hearing leakage response workbook, BRL tab), it uses the leakage data from our Annual Performance Report which is the AMP6 definition, not the standardised/shadow reporting for leakage (table 3S) which is the basis for the PR19 FD targets. This lack of clarity risks suggesting there is a dispute where none exists once these known data and reporting changes are clarified.

An incentive based on a historical three year average should allow for tighter P10 and P90 ranges rather than an annual target. The benefit of a three-year average target is that, for leakage, it helps to smooth out harsh weather impacts (the company can reduce leakage within this framework). As Bristol Water has strong control and knowledge of leakage, and the AMP7 target is an extension of measures already taken, a three-year average allows adverse impacts to be mitigated. It is perfectly possible to have two harsh winters and hot and dry summer condition years in a row that can increase underlying leakage (as can be seen 2016-18) – the P10 level is a balanced estimate of this, whilst also reflecting an ongoing improvement from investment, assuming that base expenditure maintains this. The graph above clearly illustrates a long term reduction in leakage performance over time.

The P90 level recognises that Bristol Water is operating near the frontier of leakage, including when based on the international comparisons available to us – the scope for major gains beyond the target level is reflected in the P90 level. This is based on understanding the higher marginal cost of this leakage reduction that was tested for our

March 2018 draft business plan consultation process. We included evidence on this in Annex 3 of our Reply (Information on leakage innovation and efficiency). This is particularly relevant because a key assumption on ODI P10 and P90 ranges is that they are set so as to be consistent with efficient spend allowances (as assumed in our plan) and not what performance would be possible with a different level of investment.

As well as considering the individual ODI range, Annex 9 of our Statement of Case (Bristol Water risk analysis) shows the interaction between leakage and other performance measure risk ranges as part of our Monte Carlo analysis of outcome incentives.

Note 2: Engagement request log

This highlights the main company specific correspondence and discussions in the decision-making phase of PR19 (after the IAP). It only includes company-specific activity (e.g. excluding general Ofwat webinars), and only covers PR19 activities. It excludes queries (both ways) and process management catch-ups. In addition there were 15 minute calls ahead of IAP, DD and FD for Ofwat to outline the embargoed headlines for the company.

Date	Activity	Outcome
11/11/2019	Letter from [✄] to [✄] checking if there was any possibility of further discussions to close the gap on technical matters following the FD. This was a follow-up to the letter of the 29th August 2019 from the BW Board making the same suggestion following the DD response. This reflected that very few formal queries on the key cost assessment and CSA topics had been received since the DD representation meeting.	[✄] responded on 13th November confirming that they hadn't wanted further meetings following the representation meeting, but that they valued the discussion at the representation meeting and in advance of this.
15/10/2019	Email from [✄] to [✄] (Ofwat engagement lead) and call to check on further meeting opportunities following the representation meeting.	Call confirmed Ofwat's view that no further discussion was required.
11/10/2019	DD representation meeting.	[✄] and [✄] confirm that they have everything they need from us and that there is no need for any further meetings on the points raised. Any questions would be dealt with through the formal query process.
03/10/2019	Discussion between [✄] and [✄] on the issues in advance of the DD representation meeting.	11 October meeting.
29/08/2019	Letter from [✄] to [✄] accompanying our DD – setting out the issues and suggesting technical discussion in advance of the DD representation meeting.	3 October discussion with [✄].

Date	Activity	Outcome
18/09/2019	Call requested by Ofwat to explore change in approach to developer services from the DD.	We wrote back to confirm that we understood the revised approach, although our understanding was not confirmed one way or the other.
13/09/2019	Email from [✂] to [✂] to see if exploring the technical analysis (specifically KPMG CSA calculations) would be helpful before the representation meeting.	Confirmation that suggestion would be relayed to Ofwat's technical teams.
22/08/2019	Phone call between [✂],[✂] and [✂].	Ofwat explained that, although the IAP had passed the C&RT cost adjustment claim, Ofwat now felt this was an error, and exceptionally offered this call because the DD took a different view. The call reflected that Bristol Water therefore had substantially less time to respond than if the correct challenge had been made at the IAP stage. The call was merely to check the factual basis of the new Ofwat challenge.
03/05/2019	Email from [✂] to [✂]) setting out the potential remit for a cross-industry project to explore reasons for variation of WTP rates across companies. Also included a proposal from KPMG for sharing a remit for looking at CSA topics (including valuing benefits and precision) prior to carrying out the work for the DD. [Original request for call on 26th April to follow up on key IAP response points where work may have a wider value - wholesale costs, CSA benefits and WTP variation across companies.]	Reply from [✂] stating "*I appreciate the context of this offer and the spirit in which it is made. However, it is up to Bristol Water to determine whether to conduct any further research and to consider the extent and focus of that research. It would not be appropriate for Ofwat to provide a steer on this at this point in the price control process.*"
27/09/2018	Business Plan representation meeting.	No specific follow-up or further discussion.