PR19 Redetermination

Bristol Water:

Initial response to the CMA cost of capital working papers

18 January 2021

bristolwater.co.uk

Contents

1. Executive summary

1 This submission forms the initial response of Bristol Water to the CMA cost of capital working papers. We will provide any further observations we have by 27th January 2021, including taking into account the discussion at the cost of capital round table on 20th January 2021.

2 We are very surprised and seriously concerned by the contents of the cost of capital working paper in two key areas; firstly, the complete absence of any reference to the cost of capital relevant to Bristol Water that is so important to our redetermination and our financeability, and secondly the substantial changes in the CMAs approach to key aspects of cost of capital from the Provisional Findings without adequate justification.

3 The CMA confirmed in its provisional findings that we require a Company Specific Adjustment (**CSA**) to the industry cost of capital so as to secure our financeability as a small water-only company. To the extent the CMA is proposing to make further changes to the industry cost of capital, this gives rise to significant implications for the level of our cost of capital, which the CMA does not appear to have considered. In the absence of any information on this issue, we cannot provide a proper and informed response to the CMA's consultation and consider our position to be prejudiced accordingly.

4 There are significant changes of rationale and logic compared with the PFs, and previous CMA and regulator decisions. With the background of unprecedented pressure from Ofwat since the publication of the Provisional Findings, such a drastic change in position in a short timescale, and without adequate consultation or a strong basis for doing so, will do little for the trust and confidence in the independence, stability and predictability of regulatory redeterminations.

5 You have also heard in this process from our stakeholders, including the Bristol Water Challenge Panel, who share a trust and belief in Bristol Water and its value as a small water company. They will not understand how the CMA can consult on major changes in approach without appearing to assess the impact on their water company.

6 The potential changes to the industry cost of capital have direct impact on the CSA for Bristol Water. By way of examples:

- The CMA suggests a different approach to the industry embedded debt to the provisional findings, including using a 15 year rather than 20 year trailing average, a "collapsing average" benchmark approach and with a number of cross checks. **Our assessment is that this approach is erroneous, and fundamentally inconsistent with the benchmark approach the working paper purports to take.**

- The ranges appear to be based on analysis of WaSC finances, with no discussion on how this may affect the Bristol Water CSA, particularly as the actual cost of debt cross-checks appear to show a significantly higher cost for water only companies than WaSCs. For instance, there is no reference to the cross check on Bristol Water debt costs, such as the CMA used in 2015 and the role this plays. **We show that when the impact of the new analysis presented by the CMA is considered from the correct perspective of a notional water company relevant to Bristol Water, there should be no material change to the cost of embedded debt for Bristol Water from the Provisional Findings. A cross check on**

the Bristol Water debt cost confirms this conclusion.

- It was clear from the Provisional Findings that the CSA to the cost of equity for Bristol Water was considered in the round, considering financeability from the perspective of the cost of debt for Bristol Water in the Provisional Findings. We disagreed with the CMA that it was appropriate to conclude that small companies had a higher cost of equity, but then to apply this notional principle in practice. **The working paper did not show how the evidence we presented in our response to the Provisional Findings will be considered. The working paper confirms that the CMA wishes to take a notional, not actual, approach to the cost of capital. Therefore the CSA on equity must be properly considered. The CMA cannot merely rely on evidence focused on WaSCs and assume this also addresses the evidence we have presented.**

7 There are aspects of the CMA working papers that we agree with. In particular, we agree that:

(a) financeability, if assessed properly, requires an adequate cost of capital; and

(b) the arguments for aiming up, including that asymmetric incentive risk is likely to require a cost of equity set above the mid-point implied by its estimated range, to ensure that investors can on average be expected to earn that cost of equity.

8 These are welcome findings, but equally they also then emphasise the importance of taking due account of the issues that we have raised that are not considered in the working papers. They also require the cost of debt that is used in the financeability assessment to be calculated correctly with reference to a relevant notional company. Our focus in this initial response is to ensure that in the remainder of this process, the CMA consider this necessity appropriately for Bristol Water.

9 In conclusion, the evidence for a relevant notional water only company supports, and Bristol Water will not be financeable without:

- an embedded cost of debt of c.4.9%;
- a cost of new debt with a c.0.15% CSA premium above the iBoxx benchmark;
- a new to embedded debt ratio of 5:95; and
- a CSA on the cost of equity that reflects the higher asymmetric risk on the water service, and the additional risk this provides to small companies.

2. Cost of debt

2.1 CMA's revised industry Cost of Debt position

Embedded debt

The CMA's new approach to setting the notional industry embedded debt benchmark

10 The CMA has retained its approach to using a benchmark as the tool for setting the cost of embedded debt. However, it has changed its position of using a 20-year trailing average to a 15-year "collapsing" average of the iBoxx A/BBB 10+ year index. This is unjustified, erroneous considering the conceptual basis and implications of this position and has the significant effect of reducing the embedded debt allowance (excluding CSA) by c.30bps from 4.81% in the Provisional Findings (**PFs**) to 4.52%.

11 CMA's stated reason for the change in its position on the trailing average is that it now considers that a notional cost of debt allowance should "*reflect the reality of the range of debt instruments used by the water sector.*"[1]

12 Further, the CMA now considers that even though a 20-year average of the benchmark may be suitable for the fixed element of debt incurred by water companies, it may not accurately reflect "*the range of instruments*" including short-term issuances, floating interest rate debt and bank financing.[2] In favour of the 15-year average, it offers the evidence that the actual weighted average years to maturity of debt in the sector is c.13 – 14 years, "*considerably shorter than 20 years*".[3] On this basis, the CMA is satisfied that a 15Y collapsing average provides a "*more accurate assessment of efficiently incurred costs compared to a 20-year average*".[4]

13 The CMA adopted Ofwat's and companies' views on using a collapsing average on the basis that this would be a superior measurement technique to account for debt costs over the price control compared to a straight average.[5]

The concept of a 'matching adjustment'

14 In departing from the 20-year lookback period adopted in PFs, the CMA now considers that a 20-year collapsing average could remain appropriate as a benchmark only if accompanied with an appropriately calibrated "*matching adjustment*" to account for "*non-fixed rate*" debt.[6] The CMA states that instruments that are either currently (floating rate debt) or structurally (short term or EIB debt) lower cost than the historical average of a fixed bond benchmark would warrant adjustment. It further states that some of these features could justify a "*matching adjustment*" of 40bps (specifically, it bases this estimate on adjustments for floating rate and EIB debt only).[7]

[1] CMA (2021), Cost of Debt Working Paper, para. 76
[2] CMA (2021), Cost of Debt Working Paper, para. 69
[3] CMA (2021), Cost of Debt Working Paper, para. 69
[4] CMA (2021), Cost of Debt Working Paper, para. 78
[5] CMA (2021), Cost of Debt Working Paper, para. 61
[6] CMA (2021), Cost of Debt Working Paper, para. 77
[7] CMA (2021), Cost of Debt Working Paper, para. 121

15 Under this alternative approach, the 20 year collapsing average of 4.95% would be reduced by c.40bps to get to an estimate of the embedded debt cost for the sector of presumably c.4.55% after accounting for this adjustment.

16 The CMA continues to consider that an outperformance wedge in the sense of a halo effect, where water utility bonds are compared to other sector debt on comparable like-for-like basis, is not evidenced in the data. Therefore, it is solely concerned with the need to apply an outperformance wedge in the sense of a matching adjustment to reflect features of actual financing of the sector.

Use of actual cost of debt cost cross-checks

17 Despite rejecting in the PFs the need to cross-check the industry embedded Cost of Debt derived through a benchmark-led approach with actual cost of debt data, , the CMA now appears to support the need for carefully calibrated cross checks and has checked its proposed allowance against actual average cost of debt of 4.45% (WaSCs) to 4.82% (sector).[8] It found that with no adjustment applied to the benchmark approach its cost of debt estimate of 4.52% (15-year collapsing average of the iBoxx A/BBB index) falls within the range implied by actual costs. The working paper took no consideration of the cross checks relevant to Bristol Water, such as the one carried out by the CMA in 2015, replicated in section 7.2 of our Statement of Case.

New debt

18 The CMA has corrected the measurement period to April – September 2020, with no outperformance wedge or forward rate adjustment applied to the estimate. As a result, the cost of new debt allowance has fallen from 2.38% to 2.19%. The working paper failed, however, to consider the CSA on new debt.

19 The use of updated data on new debt is inconsistent with CMA's rejection of using the latest (2019/20) cost data. We do not believe the CMA has justified such inconsistency reviewing the working papers as a whole.

Overall impact

20 The overall impact on cost of debt under the CMA's working paper is a very substantial, unprecedented and erroneous 33bps reduction in cost of debt relative to PFs which results in a reduction in WACC of 20bps. No implications for Bristol Water could be drawn from the working paper, as it did not discuss how the cost of debt should be assessed for a small notional company like Bristol Water. The cost of debt working paper stated that the Bristol Water cost of debt would be "*dealt with separately*",[9] despite the significant change in approach from the CMA Provisional Findings and previous regulatory approaches. The paper did not state how the Bristol Water cost of debt would be dealt with, which is not an acceptable approach or process, particularly for a consultation with such significant changes to the PFs at this late stage of the Bristol Water redetermination.

[8] CMA (2021), Cost of Debt Working Paper, para. 195
[9] CMA (2021), Cost of Debt Working Paper, para. 262

21 While we note that the CMA proposes to afford time to discuss Bristol-specific issues at the cost of capital roundtable, this is no substitute for the CMA setting out its views in writing by way of consultation so as to enable Bristol to provide a meaningful and informed response.

2.2 The policy of 'matching' actual financing choices for the industry as a whole when setting notional Cod is flawed in principle

22 The core of the CMA's evolved position on debt is its newly proposed view that companies' debt portfolios are comprised of a range of instruments, not just 20 year fixed rate debt, which it now considers should be reflected in the notional benchmark. The core underlying change is a significant reduction in assumed maturity of debt and hence trailing average required to compensate for it. The incorporation of adjustments for different debt instruments appears to be only a tool to justify this change.

23 The CMA's position in terms of what "*reflecting the range of debt instruments*" means for the notional financing assumptions is not entirely clear; however, based on the reasoning offered for the 15-year collapsing average, it appears that the CMA equates "*reflecting the range of debt instruments*" with attempting to match the remaining debt maturity reported by the sector (of 13-14 years) to the trailing average.

24 The CMA's discussion of a matching adjustment provides further insight into the CMA's possible view on what it considers to be appropriate notional financing assumptions "*reflecting the range of debt instruments*" in the sector. Specifically, the discussion of the need for a matching adjustment offers three specific reasons for downward adjustment to the 20-year average, for instruments that are either currently or structurally lower than the cost of debt implied by a benchmark index. These include:

(a) short term debt, which is (typically) structurally lower cost compared to the benchmark;

(b) floating rate debt, which is currently lower cost compared to the benchmark; and

(c) EIB debt, which the CMA asserts has been raised at an average of 100bps discount to market rates.[10]

25 For the reasons set out below, these adjustments are erroneous and should not be reflected in the cost of debt allowance neither for the industry in general, nor for a small notional company.

Short term debt

26 The CMA's new position on short-dated debt is misguided, inconsistent or conflicting with previous statements in the PFs and, critically, defeats the purpose of setting a notional structure for the reasons discussed below.

27 First, it is not disputed by the CMA that the average *tenor at issue* of the water sector is greater than 20 years.[11] The sector generally attracts long-term capital commitments to reflect the

[10] CMA (2021), Cost of Debt Working Paper, para. 118

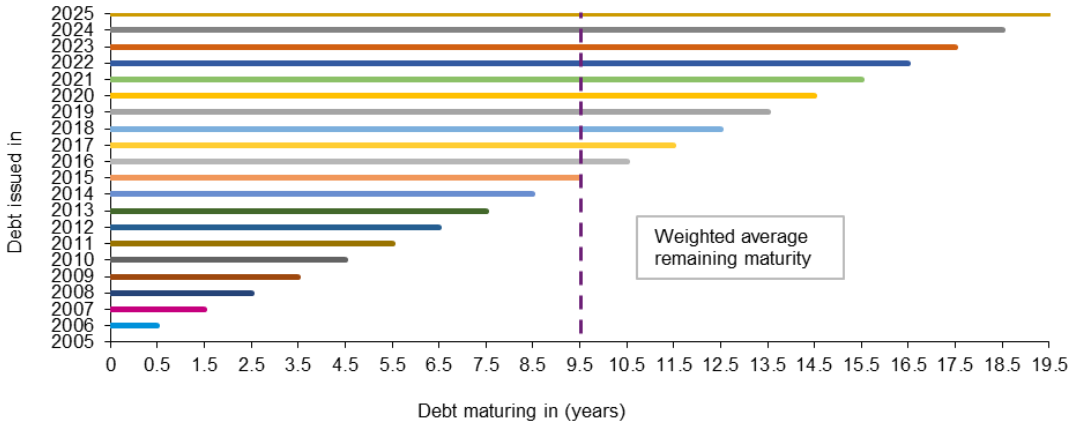
[11] CMA (2021), Cost of Debt Working Paper, para. 46, where CMA recognises work from NERA demonstrating that the average tenor at issue is 24-26yeras.

nature of the assets financed, which are long-lived. Financing arrangements are matched to the economic productive lives of the assets, with investors willing to make these long-term capital commitments given the low-risk nature of the regulated utilities business. Long-term issuance is also consistent with the principle of matching assets and liabilities, and is consistent with the underlying tenor of the benchmark A/BBB iBoxx indices all parties (including CMA and Ofwat) generally agree should be used to set the allowance. The 20 year tenor is also consistent with investment horizon adopted elsewhere in the cost of capital parameter estimates, and is consistent with Ofwat's view in the past which has been to encourage long-term financing in the sector.

28 Despite the CMA accepting that the tenor at issue is greater than 20 years, the CMA references the *average remaining years to maturity* of 13-14 years, based on APR data. The reference to remaining years to maturity is fundamentally misguided, because of the following reasons:

(a) Companies generally hold debt to maturity, which means that the cost that they incur over the life of the contract is the one that prices the term premium of the debt at issue. For water companies, the tenor at issue is 20-years or more, which means that the term premium reflected in the pricing is 20 years or more. Critically, despite the fact that once debt is issued, its years to maturity will steadily decline as it approaches maturity, the cost of this debt seen by companies does not change.

(b) Because the portfolio of debt issued in the past will reflect different issuing dates, this means that the *average remaining years to maturity* reported by each company will be necessarily lower than the average tenor at issue. Put it differently, even for a fully notional company, that *always* issues 20-year tenor debt, at equivalent annual tranches, its portfolio of debt, issued in say the last 20 years would have a reported *average remaining years to maturity* of only c10 years (see illustration below). Critically, this company, however, will continue to pay the cost of the average tenor at issue of 20 years, despite reporting remaining time to maturity of only c10 years.



29 The CMA's decision to reflect shorter term maturity is therefore wrong in principle, since the concept used to proxy the term premium for pricing debt does not reflect the term premium that companies actually pay. The CMA has apparently confused the average remaining maturity with the tenor at issue which is what companies actually pay through the life of the contracts (given the debt is held to maturity).

30 It is not in contention that small companies such as Bristol Water have both a higher cost of financing compared to larger WASCs, or that they have to efficiently issue it in larger tranches and/or longer tenors in order to minimise these additional costs. It is also not in contention that the WoCs had longer maturing debt taken out in the period 2002-2005 over 30 years through Artesian arrangements, as an efficient choice of financing at that time. The CMA working paper does not consider this factor in the change of approach to the provisional findings, despite the evidence in the working paper (Table 1 and Table 2). We explore this in more detail in section 2.4 below.

31 Second, if the CMA were to reduce the trailing average to 15 years, this approach would defeat the purpose of setting a notional structure that allows companies to assess and adopt different debt issuance strategies.

32 For example, a notional structure is intended to encourage companies to arbitrage, and therefore decide based on prevailing market conditions, whether it would be optimal to lock in long-term financing of say 20-years, or lock in 10-year financing and carry refinancing risk. Given that the current long-term rates imply forward rates priced into the future, 20-year debt would *ex ante* be expected to be priced the same as a sequential issuance based on the prevailing 10-year rate, and a refinanced 10-year forward rate, 10 years into the future.

33 Companies might decide to adopt a different financing policy, and might choose one option or the other, depending on market conditions, with the intent to minimise expected financing costs over the 20-year period. By reflecting current pricing of shorter duration, the CMA is effectively penalising companies that have made the choice to take refinancing risk, and removes the option for companies to make these strategic financing decision.

34 This shorter duration floating rate debt is not an appropriate assumption for the WaSCs given the nature of the assets financed, and is even more inappropriate for a small WoC. Such financing is not available and, even if it were, it would put financeability at risk from market changes, with lower financial headroom and refinancing options.

35 Customers do not benefit from the reduction in the tenor of the allowance if it simply means that companies as a result issue shorter dated debt. In fact, the policy would simply transfer refinancing risk to customers, with potential consequences in bills as the volatility in market rates, which translates into volatility in debt financing costs, is transferred to bills.

36 Third, related to the above, the CMA's own reasoning in PFs for the removal of the outperformance wedge is relevant. The CMA's stated reason for not applying the outperformance wedge (primarily driven by shorter dated debt) was in part because it would incentivise shorter dated debt issuance and transfer refinancing risk to customers.[12] It is not clear why CMA now attaches weight to different risk positions adopted by companies to calibrate the allowance. The policy of short-term tenor, appears to weave in an "outperformance wedge" in the sense applied by Ofwat by another name ("matching adjustment").

37 A separate question is whether, in the world of increasing interest rates (as oppose to falling interest rates over the recent years) the regulator would equally strongly argue for additional

[12] CMA (2020), 'Provisional Findings', para. 9.353

compensation for companies based on shorter tenors of debt even if, and in particular for, the companies that would have locked in longer term, lower cost of debt in the past. There is risk that in this scenario, the regulator would not take the position that prevailing market rates should be priced into the allowance. Application of a consistent long maturity benchmark is the only way to avoid arbitrary, ex post adjustments, that change along with the changes in market conditions.

38 In summary, for all the reasons above we do not consider that any adjustment to reflect shorter dated debt would be appropriate under a notional capital structure. Even if such an adjustment was appropriate for WaSCs, it would not be appropriate for a notional company relevant to Bristol Water, further discussed below.

Floating rate debt

39 Water companies have since privatisation received fixed ex ante allowances for both embedded and new debt. A number of companies have raised some floating debt and taken on additional risk and volatility of financing costs which is not reflected in the notional company structure (which has fixed allowances and has been assumed by Ofwat to exhibit fixed and index linked debt only). This has been recognised by the CMA.

40 We consider that it is wrong to adjust the assumed notional company financing debt on an ex post basis for floating rate debt for the following reasons:

(a) Conceptually, there is no basis to reflect floating rate debt in the pricing since floating rate debt is *ex ante* priced equivalent to fixed rate debt (risk adjusted) and therefore, it will be sometimes above and other times below a fixed rate benchmark. *Ex ante*, therefore, it means that there is no basis to reflect this feature in the notional financing structure.

(b) A separate question is whether it is appropriate to assume that some embedded debt cost varies with interest rates, and therefore it would be appropriate to pass through some of this cost in allowance. We disagree with this proposition because : (1) this is already taken into account by the trailing average (because it assumes that debt is continuously raised during the trailing average period) so it is a duplication, (2) assuming different types of debt instruments effectively means regulation interfering with companies' financing decisions, (3) it is selective – there are many other instruments and costs that companies use that are not adjusted for by the CMA; and (4) most fundamentally, the approach to account for this issue by the CMA has been to effectively reduce the assumed average tenor at issue below 20 years which means that it is not consistent with long term financing.

(c) Separately, it is then not appropriate to adjust for floating rate debt *ex-post*, i.e. with the benefit of hindsight having observed a fall in interest rates. At present, whilst this would not have implications for financeability for companies that have these variable rate instruments, it would wrongly penalise companies that do not have these instruments, on an *ex post* basis.

Given the long-term financing nature for water assets, it would not be appropriate to determine ex-post what an efficient financing structure or debt mix is for the notional company is (ex ante). If companies are expected to bear interest rate risk (with the

allowance intended to pass that interest rate risk to consumers), this would need clear ex-ante signalling. Without this, a prudent firm would not be able to appropriately structure its debt book for the future.

(d) Moreover, assuming that floating rate issuance will achieve a lower cost of debt throughout the price control is not realistic as this presumes that variable outturn rates will remain consistently lower than the benchmark, which need not be the case. The CMA is setting a forward-looking allowance, and the CMA has recognized that these variable rates will be sometimes above and other times below the benchmark;

(e) Adjusting for floating rate debt is inconsistent with the approach the CMA adopted on the outperformance wedge, which recognises that different financing risks adopted by companies should not be transferred to customers, consistent with the idea of a notional cost of debt allowance where companies bear the risk of their financing choices.

41 For all of these reasons, there is no basis for adjusting for floating rate debt in the notional cost of debt allowance.

42 Separately, the CMA has estimated the impact of floating rate debt for the notional company by estimating the proportion of floating rate debt on company balance sheets assuming that this debt is priced at March 2020 using a 6 month trailing average of iBoxx A/BBB 10+.

43 The CMA considered the proportion of floating debt across the sector in 2018/19 (on the basis that 2019/20 company positions might be distorted by additional liquidity requirements arising from Covid). The higher end of its range based on a simple average across the sector (12%, which has an impact of 31bps) whereas the lower end based on the median (6%, which has an impact of 15bps).

44 The upper end of the CMA's range should not be taken into account. This is because the CMA is wrong to have relied on the simple average to inform its assessment as this attaches weight to outlier companies (e.g. Hafren: 54%, Yorkshire 26%, South West 20%) which have adopted very different risk positions to that assumed for the notional company.

45 The CMA has not made any adjustments to exclude floating rate credit and liquidity facilities from 2018/19 reported company positions. This would reduce the median proportion of floating debt. Analysis of 2019/20 company positions excluding all credit facilities implies floating debt of 5.5% and an impact of 14bps.

46 Overall, whilst we disagree that there is any basis to adjust for floating rate debt, which is fundamentally wrong for the reasons outlined above. Even if the CMA were to adjust for floating rate debt, the actual impact should be significantly lower than the CMA's estimate, i.e. only up to 14bps, based on adopting a 5.5% floating debt assumption across the sector (and excluding RCFs). In any case it shouldn't apply to small WoCs, which we consider later.

EIB debt

47 EIB debt has terms and conditions, e.g. covenants which do not apply for the notional company and impact pricing and transfer additional risks to equity. EIB debt is hardly new (or increasing in availability), so it is clear these are good reasons of regulatory policy why it has not been

included in cost of debt calculations until now. Therefore, the CMA should place caution before making an adjustment for EIB debt on the notional financing structure.

48 In any case, the CMA has overstated the size of the EIB adjustment for the following reasons:

(a) the variance between the iBoxx benchmark and EIB debt is lower than the 100bps assumed by the CMA; and

(b) the CMA has over-estimated the quantum of EIB debt outstanding across the sector.

49 Preliminary analysis of EIB debt suggests that it may be structurally cheaper that the benchmark by approximately 60 – 70bps.[13]

50 This finding is consistent with the analysis of the Infrastructure Forum, which estimates that EIB debt is typically 50 – 100bps cheaper than alternatives:[14]

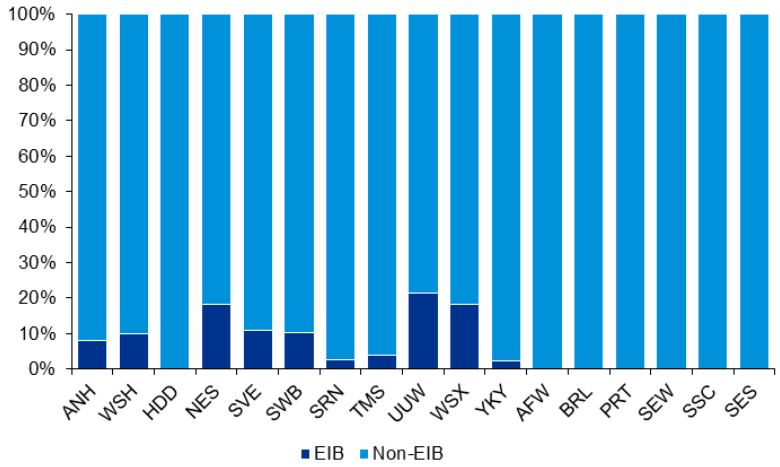
> "*The Infrastructure Forum agreed that the private sector could play a greater role, noting that routine project finance outside of economic downturns is available from the private banking sector for "most current users of EIB loans", albeit at "significantly higher cost". It cited utilities markets as one example where it would be "relatively straightforward to replace EIB finance". However, it estimated that this would increase the cost by 0.5–1.0 percentage point above the rate of interest offered on EIB loans, a cost which would ultimately be passed on to consumers.*"

51 An analysis of company's annual reports shows that EIB debt at the beginning of AMP7 is c. £5.3bn (9% of debt), falling to c.£2bn by the end of AMP7 or 6% of embedded debt.[15] This is materially lower than the £7bn balance estimated by the CMA based on simplifying assumptions on average across AMP7.[16] Moreover, this EIB debt is not distributed evenly across WaSCs, so it may not be appropriate for the average to be captured in assumed notional company financing.

52 The figure below illustrated the proportion of EIB vs. non EIB debt for companies in the sector.

[13] Based on analysis modelling the iBoxx yield curve at the date of each EIB issue and benchmarking the EIB yield against the relevant point on the curve will be submitted alongside the full response on 27 January 2021.
[14] Referenced by the Lords Select Committee in its Brexit impact assessment
[15] This reflects the maturity of some instruments during AMP7 as well as the amortising nature of most of EIB debt.
[16] CMA is assuming equal annual issuance for the total £16.6bn debt issued by sector since 1973 and a consistent 20-year life and as a result that 20/47 of this would still be in company debt books today

Figure 1 Proportion of EIB debt in company portfolios



53 Assuming a 65bps impact on pricing and c.7.7% EIB debt on average across AMP7, the impact of EIB debt is estimated to be c.5bps, which is 7.5bps lower than estimated by CMA.

54 The impact of the floating rate debt on the industry benchmark is also overstated, and in any case should not be assumed given the long term nature of the water sector. As we stated at our hearing and explain in the next section, EIB debt has not been available to small water only companies, and appears to no longer be an option more widely.

Conclusion

55 Overall, we consider that CMA should (consistent with its PFs) price long term financing consistent with the iBoxx benchmark selected. The trailing average period should conceptually be matched to the tenor at issuance implied by the benchmark, which is around 20 years based on the iBoxx 10Y+ benchmark selected. This ensures that the a company issuing 20 year debt on a continuous basis can expect to recover costs equal to the yield at issuance across the maturity of each instrument. However, even if a 'matching adjustment' were to be applied to the 20 year collapsing average (which we disagree with in principle), we evidence that the CMA have overestimated any such adjustment.

56 Ultimately the CMA's analysis appears to confuse the tenor at issue and timing of issuance on the one hand with the average remaining years to maturity on the other hand. This is a clear error. A 20 year collapsing average of the iBoxx index with 20 year tenor would be the internally consistent assumption, given the CMA's acceptance that companies in the sector issue on average debt with tenor of 20 years or more. We are concerned that the change in industry cost of debt since the Provisional Findings is based on analysis which has been assessed incorrectly, and does not achieve the aim of being consistent with the benchmark.

2.3 The policy of 'matching' actual financing choices for the industry as a whole when setting notional Cost of Debt is flawed in particular for a notional small company

57 The adjusted benchmark approach to setting the cost of debt which matches the three features identified above for average actual company financing would severely penalise a small company, for which the discounts associated with the 'matching adjustments' above are not available. Specifically:

(a) small companies cannot, or find it economically inefficient, to frequently issue shorter dated and lower sized tranches of debt;

(b) small companies cannot readily access EIB debt; and

(c) floating rate debt is typically more expensive for small companies.

58 It is not appropriate to approximate features of actual company financing for the small notional company, and even if the CMA were to apply such adjustments for the industry, these would need to be reversed when setting the allowance for a small company. These are discussed in further detail below.

Short-term debt

59 As a small company, our issuance profile is lumpy and more concentrated relative to that of larger WaSCs. This is because:

(a) We generally require smaller tranches of financing compared to the financing needs of other large companies. However, the market for small ticket sizes is illiquid as small ticket sizes attract fewer buyers. As a result, accessing public debt capital markets is made more difficult, and if we were to do this we would need to pay high illiquidity premia.

On the other hand, to achieve scale that attracts investor interest, we would need to increase the ticket size and face large cost of carry.

These factors make it uneconomical for a small company such as Bristol Water to attempt to access debt capital markets frequently on a continues basis, whilst locking in only short-term financing.

(b) Separately, a large part of the transaction costs associated with issuing debt (or accessing bank financing) is fixed and not scalable (e.g. including fiduciary agents, lawyers, registration, rating agencies, arrangement fees, etc). These costs constitute a higher percentage of smaller issues and make frequent issuance uneconomical for a small company like Bristol Water.

Locking in long-term financing is therefore strongly preferable for us, because we will only need to pay the transaction costs once.

60 As a result, debt issuance for small WoCs will always be more concentrated and lumpy, with strong preference for locking in long-term financing. In fact, this was one of the main attractive elements of Artesian financing at the time Artesian debt was raised. Considering our current debt portfolio at the moment, the average tenor at issue is c.23 years, which means that the

average term premium we pay on our debt (even if we were to assume the iBoxx index price available to e.g. a large WaSC, which in practice we cannot achieve) is higher than the CMA's 15 years.

61 A small company that is a less frequent issuer and can only issue (say) every few years, will need to pre-finance in order to best match the regulatory allowance the will have to take risk and bear the cost of carry on each point of difference. This can result in significant accumulation of cost of carry over time. A hypothetical portfolio of debt that 'mimics' the proposed regulatory policy and requires continuous issuance in line with changing rates is not only inconsistent with how a small company would actually choose to issue debt, but also would be significantly more expensive.

62 Separately, shorter term financing reflects liquidity requirements (e.g. RCFs) and short term opportunities on the limited occasions when these opportunities arise. We have submitted extensive evidence of the uncertainty of refinancing, and of the higher transaction and other costs this strategy entails.[17]

EIB debt

63 We do not have any EIB debt in our portfolio and our experience is small companies in general have restricted access to EIB funding. In part this is due to the use of Artesian facilities by smaller companies.

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Floating rate debt

66 While we do have floating rate debt, some of which is for short term liquidity management and not for RCV financing that the allowance is related to, this debt is still relatively more expensive for small companies. ✂[18]
✂[19]
✂[20]

[17] e.g. Bristol Water Response to Provisional Findings pages 22 – 31.
[18] Bristol Water (2020), Response to Provisional Findings, p.27 – 29.
[19] Bristol Water (2020), Response to Provisional Findings, para. 119
[20] Bristol Water (2020), Response to Provisional Findings, para. 128

67 ✂

68 ✂

69 As discussed above, an appropriate analysis of the floating rate structure over the life of the contract, on an *ex ante* basis, shows that this loan was priced in fact more expensive than equivalent market benchmarks available to large companies at the time.

Conclusion

70 Overall, the above shows that any discount to iBoxx due to a matching adjustment for the industry would not be available for a small company because (1) our issuance is lumpy and we cannot access cheap short-duration sources of finance on a frequent basis; (2) we have not been able to access EIB loans; and (3) our variable loans are more expensive than comparable benchmarks available to large companies. Therefore, whilst we disagree with the concept of a matching adjustment altogether for the industry as a whole, we in particular consider that if the CMA were minded to apply such an adjustment, it would need to be reversed for the allowance for a small notional company which cannot achieve such a matching adjustment.

2.4 The CSA for a small company would need to be larger to reflect actual cross checks as indicated by all relevant cross-checks

71 In this section, we set out cross-checks on our position of the notional cost of debt for a small company, which further corroborates the discussion above, demonstrating that the actual costs of financing for a small company are significantly higher than that for a large WaSC.

72 In its working paper, the CMA has updated its position on the cost of debt. Overall, without considering any change to the CSA, the embedded cost of debt allowance is c.30bps lower than the CMA's PF of 4.81% (excluding the CSA). However, these changes do not fully consider the implications for us as a small company.

73 Consistent with the approach adopted by the CMA in 2015, in its PR19 PFs, the CMA also considered that a cost of embedded debt of 4.92% was reasonable allowance for both a notional small company and Bristol Water, based on cross-checks to our actual cost of debt finance:

> *"We do, however, compare this figure to Bristol's actual embedded debt costs as a sense check. In nominal terms,* ***our CSA-based cost of embedded debt estimate would be 4.92%, a figure that sits between and close to both Ofwat's estimate of Bristol's actual cost of debt of 4.73% and Bristol's estimate of 5.09%*** *(see paragraph 9.465). As such, we consider this estimate to be a reasonable allowance for embedded debt for both a notional smaller company and Bristol specifically."*[21] [emphasis added]

74 Given the changes signalled from the PF and the CMA's focus on the cost of debt for WaSCs, cross checks from a relevant notional water only company rather than from a WaSC perspective are necessary and critical to ensure that the overall cost of debt set for a small notional company is appropriate and does not leave the company in a non-financeable position, where efficiently incurred historic cost of debt is *ex post* disallowed.

75 Whilst the CMA has not been explicit whether the adjustments to the notional industry cost of debt will have implications for the quantum of the CSA awarded for a small notional company, we consider below the consequences of an outcome where the CMA's current proposition on embedded debt for the industry is carried forward (at nominal 4.52%), and CSA remains at 10bps per the PFs. The table below outlines several cross-checks on the appropriateness of this cost of embedded debt of 4.62% (4.52% + 0.10% CSA) set out in the CMA's working paper (noting our response to the PFs that the CSA uplift should be c0.2% that has not been assessed for this working paper[22]). These include:

(a) precedent set in the CMA's redetermination for Bristol Water in 2015 which used the company's actual cost of debt as a cross check; and

(b) the CMA's overall cross checks on actual company cost of debt in its working paper.

CMA (2015) precedent for Bristol Water

[21] CMA (2020), 'Provisional Findings', para.9.491
[22] Bristol Water Response to CMA Provisional Findings (section 11)

76 We have calculated an updated actual cost of debt for Bristol Water applying the methodology set out by the CMA in 2015. This indicates an actual embedded cost of debt in the range 4.71% to 4.99%, with a mid-point of 4.85% which is consistent with our view (and the CMA's PFs estimate) of 4.92%. The analysis was updated for the latest debt balances and the CMA's view on Long Term inflation.

Cost of embedded debt calculation	Fixed	Floating	Index linked	Total
Bristol Water Debt (as at March 20), £m	84.07	102.74	193.78	380.59
Nominal interest rate	4.96%	1.62%	6.31%	4.75%
Long term inflation	2.90%	2.90%	2.90%	
Real interest rate	2.00%	-1.24%	3.41%	
Real interest cost, £m	1.68	-1.28	6.61	7.01
Weighted real interest rate				1.84%

CMA adjusted cost of embedded debt	Low	High
Weighted real interest rate	*1.84%*	*1.84%*
CMA adjustments		
Adjust for yields of Artesian debt	*-0.17%*	*-0.17%*
Remove Artesian used for parent loan	*-0.11%*	*-*
Issuance costs	*0.10%*	*0.16%*
Cash holding costs	*0.10%*	*0.20%*
	-0.08%	*0.19%*
BW's CMA real cost of embedded debt	*1.76%*	*2.03%*
BW's CMA nominal cost of embedded debt	*4.71%*	*4.99%*
Long term inflation	*2.90%*	*2.90%*

CMA cross checks on actual cost of debt set out in its working capital paper

77 In its position paper, the CMA has re-presented Ofwat's APR data adjusted for inflation assumptions.[23] It is clear from this that cost of debt for WoCs is considerably higher than that of WaSCs. In particular, the average WaSC cost of debt is 4.08% – 4.45% assuming a company specific weight average of debt type and assuming 2/3 Fixed rate 1/3 ILD respectively. For WoCs, this range is 4.88% – 5.29%. This implies a much greater difference than the 0.1% CSA assumed.

78 This position still holds if we account for the adjustments made by the CMA, which finds an average cost of debt of 4.45% for WaSCs , but a sector average of 4.82%.[24] Given that the sector average is comprised of both WoCs and WaSCs, we consider this to be a floor on the cost of debt for Bristol Water. Applying the CMA's CSA of 0.10% to this would imply a cost of debt estimate of 4.92% which is consistent with our position on the embedded cost of debt.

[23] CMA (2021), Cost of Debt Working Paper, Table 1, p.49
[24] CMA (2021), Cost of Debt Working Paper, para. 168 - 169

79 The CMA states that certain features, i.e. finance instruments that are either currently (floating rate debt) or structurally (shorter term of EIB debt) lower cost than the historic average of a bond benchmark, could justify a matching adjustment which reduces actual company debt costs by up to c.40bps on average vs. a 20-year average of the iBoxx A/BBB 10+ year benchmark.[25]

80 Any matching adjustment must be added back to the CSA given that applying matching adjustments to a small notional company is flawed as set out in section 2.3 above.

Table 1 Cross-checks on embedded cost of debt (nominal)

Basis	Starting position on CoD	Adjustment	CoD for a notional WoC
CMA Provisional Findings	4.81%	CMA: 0.10% CSA BW: 0.20%	**4.91% – 5.01%**
BW Statement of Case	4.47%	BW: 0.38%	**4.85%**
Ofwat FD	4.47%	0.35% CSA for Portsmouth& South Staffs, would have applied to BW except for the "customer benefits test", which the CMA rejected use of in the PFs	**4.82%**
BW actual cost of debt, applying CMA (2015) methodology	4.71 – 4.99% (midpoint of 4.85%) Same methodology as CMA 2015	Note: BW's actual debt costs are lower than that of other WoCs with similar characteristics	**4.85%**
20Y collapsing + Matching adjustment	4.95% – 40bps 20Y collapsing – CMA matching adjustment	Wright & Mason matching adjustment equivalent to 0.40% (from floating rate debt and EIB debt) should be added to the CSA.	**4.95%**
WoC Average CoD (CMA table 1)	4.88 – 5.29% (Depending on weight placed on floating debt)	n.a.	**4.75% – 5.41%** for Bristol Water
Industry Average CoD for WaSC v. sector avg. (CMA table 2)	4.45% (WaSC)	0.37% difference between industry avg of 4.82% and WaSC avg of 4.45%	**4.82%** (Industry average should be used as a min. for BW)
Industry avg. cross check + CSA	4.82%	0.10% CSA (given BW cross check as per CMA 2015 approach)	**4.92%**
Non-listed WaSC average (CMA table 2)	4.73%**	Listed WASCs removed as outliers* CSA uplift of 10-20bps assumed for a WoC per PF and our response	**4.83% - 4.93%**

[25] CMA (2021), Cost of Debt Working Paper, para. 121

Overall range implied under all cross checks		**0.1% – 0.4%**	**4.75% – 5.41%**
Overall range implied under all cross checks (excluding outliers)			**4.75% – 5.01%**

* Listed WaSCs are outliers as they have very low cost of debt due to higher floating rate debt and this then allows significantly higher dividend yields than others, which affects investor view on cost of equity, because of embedded financing outperformance. Despite having similar gearing to Bristol Water, such debt financing structures are not and have never been available to Bristol Water.

** 5bps added as conservative assumption for other adjustments, lower bound of CMA position paper.

Conclusion on cross check on embedded debt

81 The cross checks identified indicate a range for WoCs embedded debt of **4.75% to 5.41%** with a mid-point of c.5.08%.

82 However, we remove one outlier, the WoC average approach reported by the CMA, which calculates a fixed/index linked split actual cost of debt for Bristol Water of 5.41% which sits outside the rest of the range.

83 Taking the above into account indicates that a suitable range for WoCs embedded debt cross-checks is **4.75% to 5.01%** with a mid-point of **c.4.88%** which is consistent with our position of **4.91%.** While the notional approach the CMA prefers in the working paper suggests a slightly higher value of c.5% as we described in our response to the PFs, the CMA 2015 precedent of the Bristol Water specific cross check supports a slightly lower number.

84 Taking the evidence in the working paper as a whole, it suggests that the embedded debt cost for Bristol Water is the same as the CMA found for the PFs. Our analysis demonstrates that it is unlikely to vary for the differences in analysis approaches between the working paper and the PFs. As the PFs included the Bristol Water cross check and financeability tests, it appears from our analysis that the working paper does not affect this conclusion. This is important, because of the critical impact it has on financeability and on the conclusions that the CMA reached in the PFs, and the basis on which we and other parties have responded to. A different conclusion should require further consultation on the impacts on Bristol Water.

85 Therefore, the CMA's cross checks for Bristol Water fully supports an embedded cost of debt allowance of c.**4.9%**, which is the appropriate cost of embedded that should be assumed for a small notional company, for instance in a financeability assessment as set out in section 6 below.

3. Cost of new debt

86 As set out in our response to the PFs, as a small company, we are unable to raise financing at the same price as large WaSCs and estimate that we would incur at least 10bps higher coupon cost compared to relevant benchmarks. We found that a CSA of 15bps on the cost of new debt

represents a conservative estimate, which is comprised of a 10bps premium on the coupon rates and 5bps of excess transaction costs above the CMA's allowance.[26]

87 The updated analysis presented in the working paper does not affect or change any of the evidence we set out in our response to the PFs, i.e. that smaller companies have a higher cost of new debt. Therefore the working paper does not change the requirement for a CSA of 15bps on new debt.

88 The rationale for applying a CSA in the past (i.e. on embedded debt) still holds for new debt.

(a) Due to the need to issue in smaller tranches, we face limited choice of financing options, and often need to rely on bank loans, which can be more expensive than public debt issued at scale. Bank loans also require more restrictive covenants. As a result, the pricing we can achieve is less competitive compared to the iBoxx after controlling for tenor and rating.

(b) ✂[27]

(c) We are not able to easily access public debt capital markers, which is more accessible for companies with wastewater (environmental) assets due to the high transaction costs. This is still not available to WoCs such as Bristol Water, and is not available at the relatively low cost observed historically. Even if we were to issue in public debt markets, we would not be able to achieve the same price as a large company because small issuances attract fewer buyers and are subject to illiquidity premia.

(d) The transaction costs of accessing public or private debt markets are often fixed and not scalable (cost of fiduciary agents, lawyers, registration, rating agencies, arrangement fees, etc). These costs constitute a higher percentage of smaller issues and make frequent issuance uneconomical for us.

(e) Debt issuance in the past has been infrequent with generally higher transaction costs, including the cost of carry. This is still the case.

89 Overall, the industry cost of new debt should be adjusted to recognise a CSA of 15bps for Bristol Water.

4. New to embedded debt ratio

90 In its working paper, the CMA updates it analysis to factor in the move to a 15-year lookback horizon and collapsing average approach.[28] It also accounts for the additional debt required to

[26] Bristol Water (2020), Response to Provisional Findings, section 12.
[27] Bristol Water (2020), Response to Provisional Findings, section 12.2
[28] CMA (2021), Cost of Debt Working Paper, para. 254

finance RCV growth with the AMP.[29] Taken together, the CMA finds an updated range of 18% – 22% and a point estimate of 20%, compared to the 17% – 21% range under the PFs.

91 Our analysis implies that the updated calculations are erroneous. We note for instance the errors that Yorkshire Water has identified in recent correspondence. However, in any case the CMA does not discuss in the working paper the evidence we have provided on the appropriate embedded to new debt ratio for a small water only company such as Bristol Water.

92 As set out in our Statement of Case and response to the PFs, small companies are expected to issue 0% – 10% of new debt over AMP7, therefore an 5% assumption on new debt is appropriate for a notional small company.[30]

93 Small WoCs systematically differ in their debt issuance profile compared to large companies. Debt issuance for small WoCs will always be more concentrated and can consequently result in a significantly higher proportion of embedded or new debt relative to the 'average WaSC', which is likely to vary considerably across regulatory periods.

94 As a small company, our issuance profile is lumpy relative to that of larger WaSCs. As a result, we have considerably different weights on embedded debt relative to the industry across regulatory periods. It is important to set the relevant proportion of embedded to new debt in each regulatory period given that overall cost of debt performance against the allowance is not just a function of the weights on new and embedded debt, but also of the prevailing interest at the time. Bristol Water currently has a significantly greater proportion of embedded debt relative to that assumed in the allowance, and given that embedded (under the current conditions) is more expensive than new debt, we will underperform on the cost of debt.

95 Critically, it cannot be argued that this issue will "average out" over time, as has been argued by Ofwat. This is because whether we end up being above or below the notional cost of debt allowance will depend on the interaction of weights and rates in the future. There is nothing in the mechanism for setting the allowance that ensures that these will move in a way that will allow us to recover costs through time. For example, while we are currently 'on the wrong side' of the allowance, because we have more expensive (embedded) debt that has a higher weight than the notional embedded debt in the allowance, in the future, we might face greater need to issue new debt than the average company in the sector, which in turn might coincide with a time when prevailing interest rates are high, leaving us again on the 'wrong side' of the allowance.

96 Moreover, because our actual refinancing needs over AMP7 are so significantly different than the industry average, this has material implications for the overall cost of our debt portfolio vs the allowance. Assuming the rates on embedded and new debt are 'correctly' determined for a notional company, the impact of 20% embedded debt vs 5% embedded debt is 4.5% vs 4.88%. This has significant implications for our financeability position, and exposes us to risk which we cannot control.

97 A 5:95 new to embedded debt ratio is typical for WoCs at PR19. This is not expected to change materially given that smaller companies have less new climate change or resilience investment needs compared to larger WaSCs.

[29] CMA (2021), Cost of Debt Working Paper, para. 253
[30] Bristol Water (2020), Statement of Case, para. 228 - 236

98 The lumpy debt profile for small companies is driven by investment and refinancing needs, which management has limited ability to control. This means that management has limited control over how much debt a small company such as Bristol Water can issue or time refinancing for when interest are likely to be favourable. This supports the position that it is not appropriate to assume that 'weights will average over time' as has been argued by Ofwat, because we have limited ability to control the timing of our (re)financing needs.

99 The CMA should therefore set the embedded: new debt ratio based on the needs of a typical small company requirement in the current regulatory period, else it risks creating a significant financeability problem by exposing us to risk we cannot control.

100 Overall, a new to embedded debt ratio of 5:95 is appropriate for a small company such as Bristol Water.

5. Cost of equity

101 We welcome the CMA's recognition that aiming up is appropriate because it has the benefit of:

(1) addressing the level of risk associated with setting the cost of equity too low in the context of a sharp reduction since AMP6;

(2) addressing asymmetry in the broader financial settlement; and

(3) addressing the risks to financeability from setting the cost of capital at lower levels within the range.

102 Nevertheless, the CMA has reduced the extent of aiming up from 50bps to 25bps. We do not agree with this lower amount of aiming up than in the PFs, but view that this can be addressed through a CSA uplift on the cost of equity as that is supported by the evidence.

Aiming up due to asymmetry in the price settlement

103 In its PFs, the CMA has partially addressed the asymmetric risk in the package through:

(1) adjusting some of the ODI rates, and taking account of negative ODI RoRE asymmetry (to some degree) in the setting of the cost of capital;

(2) setting cost sharing rates at 45:55 (compared to Ofwat's final determination of 40:60); and

(3) removing the gearing outperformance sharing mechanism.

104 Overall, while this reduced certain aspects of the negative asymmetry, the package nevertheless remained negatively asymmetric to a material degree. Indeed, for outcome delivery incentives, the asymmetry had become more negative due to the increase in leakage penalty rates.

105 In setting the cost of capital, the CMA recognised that asymmetry should be reflected so that companies have the prospect of recovering the allowed cost of capital on a mean expected basis. The CMA then calculated a range of 10-20bps as the expected loss due to downside ODI risk, a

measure which it considers to be an approximation of the true expected loss due to asymmetry, but which it nevertheless did not update in its latest working paper.[31]

106 As set out in the Balance of Risk section of our Response to Provisional Findings,[32] we updated the ODI analysis based on the CMA's provisional findings and showed that for Bristol Water, the expected loss resulting from asymmetry in the base case was equivalent to 0.5% of RoRE on a mean expected basis, which would result in equity investors earning a considerably lower return than required. The effect would be exacerbated given the lower starting point for the Cost of Capital per the working paper.

107 The asymmetric downside skew in RoRE is more pronounced for Bristol Water as a small company (relative to larger comparators), due to our higher operational leverage, i.e. the fact that our equity risk is more concentrated given our small RCV and resulting thin margin. The expected loss from downside risk should be reflected in the returns allowance as recognised by the CMA in order for the investment to remain to be a 'fair bet'.

108 We present the impact of asymmetric downside risk on financial ratios under the CMA's proposed outcome in Provisional Findings and as revised in its position papers, in section [X] below. Our assessment demonstrates that the settlement will result in an exacerbated financeability challenge during PR19.

109 As shown in the financeability analysis in section 6 below, an adjustment to the Cost of Equity remains necessary to account for the operating leverage risk we face as a small company in order to ensure that we are financeable.

Setting CoE too low in the context of a significant reduction vs PR14

110 The CMA's Cost of Capital working paper highlights the CMA's concern with setting the Cost of Equity too low, in particular in the current context, given the very significant reduction in cost of capital relative to PR14. Specifically, the CMA states:[33]

> "*…regulation should create a supportive long-term investment environment. The long-term investors in infrastructure that the companies need to attract to support a long-term low cost of capital will not be attracted if there are frequent sharp changes to the way regulators determine the cost of capital. An approach which is both cautious in responding too quickly to market fluctuations and is consistent over time should ultimately deliver benefits to both investors and, through a low cost of capital, to customers.*" [emphasis added]

111 Yet, despite this, the CMA has not considered that the implied scale of change in the Cost of Equity since PR14 is not only significant but also greater for Bristol Water than for other companies, because not only is the Cost of Equity reduced based on latest market evidence, but also the CMA is currently not proposing to include a CSA uplift on equity, which stands in direct contradiction to its decision in 2015 where such uplift of 13% on beta was included.

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[31] Cost of Capital working paper, para 83.
[32] Full ref [section 19]
[33] CMA, Choosing a point estimate for the Cost of Capital –Working Paper, para 103(a).

112 Namely, the CMA's point estimate in 2015 for our Cost of Equity was 5.73%, higher than the 5.65% in Ofwat's FD because of (amongst other) the CSA (real RPI figures using 2.8%). The CMA's determination was therefore set at 6.56% (CPIH real) vs Ofwat's at 6.48%. At 5.08%, the PFs resulted in a reduction of 23% from the CMA's PR14 decision for Bristol, and 26% based on the cost of capital paper. For the large WaSCs, the reductions are lower given Ofwat's Cost of Capital allowance was lower than our determination by the CMA at PR14.

113 These reductions are implausibly high given the increase in risks inherent in the PR19 framework (by design and increasing service levels and efficiency assumptions), and they are affected by the removal of the CSA uplift which was part of our Cost of Equity allowance at PR14. We consider that this is inconsistent with the CMA's own logic to apply a cautious approach and remain consistent with (its own) previous regulatory precedent, as stated above. Given that there is no new evidence or change in circumstance since PR14 on the logic for applying an uplift to the Cost of Equity, the appropriate remedy is for the CMA to restore the CSA uplift on equity, and therefore restore our financeability.

The CMA's updated position on MARs evidence

114 At Provisional Findings, the CMA appeared to consider that the evidence from market transactions (MARs) and specifically the evidence from the Bournemouth merger, was 'compelling new evidence' against the need for CSA on the cost of equity:[34]

> "*…We note Ofwat's evidence that since our Bristol PR14 Determination, small companies have been purchased at a significant premium (see paragraph 9.498). We also note that even the 'low premium' example of Bournemouth-South West suggested by Bristol (see paragraph 9.515), the assets were purchased for well above RCV value. "*
>
> *On the basis that none of the companies acquired at a significant premium benefitted from a cost of equity uplift through a CSA, the transactions suggest that highly informed purchasers do not consider there to be a material uncompensated systematic risk present in price controls for smaller water companies.* ***We find this to be compelling new evidence against the need for an uplift to the cost of equity allowance.***" [emphasis added]

115 In its working paper, the CMA now considers that evidence from MARs and transactions is company specific and cannot be used to make conclusive statements about the appropriateness of the cost of capital for the rest of the sector.[35]

> "*On balance, we remain cautious about using market prices to determine the point estimate for the cost of capital, particularly within the kind of range (maximum 0.2% differential in WACC) that we considered in PFs. We agree with Ofwat that there is no evidence from changes in these market prices during and since PR19 that its cost of capital is too low.* ***However, this evidence relies on the market view of only two companies, both of which have lower than average embedded debt costs. This is not sufficient evidence of the WACC estimate's appropriateness for the entire water sector, nor to arbitrate between an allowance that is at the midpoint or 0.1%-0.2% higher in WACC terms.***" [emphasis added]

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34 CMA (2020), Provisional Findings, para 9.526 and 9.527.

35 CMA (2021), 'Water Redeterminations 2020. Choosing a point estimate for the Cost of Capital – Working Paper', para 91.

116 We agree with this position and ask the CMA to reconsider the evidence for CSA in light of its revised position on market and transaction evidence.

6. Financeability

117 We support the CMA's view that "*financeability should be a valuable cross-check*" on the cost of equity[36] and that credit ratios should be broadly consistent with high-quality ratings. However, for a small company like Bristol Water, it is necessary (given the requirements of the Finance Duty) to also consider the implications of the CSA required on the cost of debt in order to ensure a financeable outcome.

118 As illustrated in the table below, the AICR implied under the WACC set out in the CMA's working paper is 1.57x (little change from the PFs). This reflects a notional financing cost for Bristol Water, which for the reasons we set out in this response is incorrect, and therefore is inaccurate.

119 As set out above, an allowed cost of debt of 4.23% for Bristol (including the 0.10% CSA on embedded debt from the PFs) inappropriately reflects the cost of debt for a small water company.

120 We assess financeability under the WACC in the CMA's working paper, but assuming a cost of debt (on the cost side) of 4.88% (nominal), which better reflects the notional cost of debt for a small company such as ourselves. This is set out below:

(a) cost of embedded debt of 4.81% (nominal) as per the CMA's provisional findings plus CMA's estimate of 0.10% for the CSA (section 2);

(b) cost of new debt in line with the CMA's working paper of 2.19% (nominal) plus a CSA of 15bps (section 3);

(c) proportion of embedded to new debt of 95:5 (section 4); and

(d) issuance and liquidity costs of 0.10%.

121 Under this scenario, the AICR drops to 1.32x which is close to the minimum threshold of 1.3x consistent with a Baa2 rating. This suggests that the notional company would not be financeable at the current allowed cost of debt. Moreover, these efficient unfunded debt costs would also erode projected equity returns across AMP7 as they would come at the cost of equity holders.

Table 2 Implications of AICR on projected credit metrics

	CMA PFs	CMA Working Paper	CMA Working Paper + CoD of 4.88%	+ 0.15% RoRE penalty due to asymmetry	0.5% RoRE penalty due to asymmetry
AICR	1.54x	1.57x	1.32x	1.30x	1.24x

[36] CMA (2021), 'Water Redeterminations 2020. Choosing a point estimate for the Cost of Capital – Working Paper', para.98, and 113

S&P FFO / Net Debt	13.8%	13.7%	12.95%	12.83%	12.83%

Source: Bristol analysis of Ofwat model and CMA financial model

122 Accounting for the level of asymmetry in the package, which has been recognised by the CMA (estimated to be 0.1 – 0.2% of RoRE) has the effect of reducing the AICR by c.0.02x to 1.30x. This means that in the CMA's base case, AICR is effectively 1.52x, which is only slightly above the minimum thresholds of 1.5x for Baa1.

123 As set out in our response to the PFs, the expected loss resulting from asymmetry in the base case is equivalent to 0.5% of RoRE on a mean expected basis. Under this scenario (including the higher cost of debt), AICR drops to 1.24x. This is before taking into account the base costs (totex gap) required to deliver our plan, which we identified (in our response to the PFs) as having a 0.33x reduction in AICR.[37]

124 In order to meet the objective stated in the CMA working paper to support financeability, it is necessary for this to be tested based on a notional cost of debt, and in particular embedded debt, that is realistic. Any change in the cost of debt from the PFs, needs a specific consideration of financeability relevant for a company like Bristol Water, so the financial ratios remain consistent with the credit rating assumed in the benchmark. Given the significant change in approach and the cost of debt and equity signalled in the working paper from the Provisional Findings, to secure the Finance Duty the CMA must consider the impact on Bristol Water, based on a realistic cost of debt.

125 Our assessment of the working paper is that the embedded cost of debt, including that used for testing the overall redetermination, should not be materially different from the Provisional Findings. The issues we raised on new debt, embedded to new debt ratio and CSA on equity also require sufficient consideration and recognition. Based on the working paper alone, there is a significant risk to the process necessary to complete a reasonable redetermination without considering the impact on Bristol Water and its financeability. Any other approach would be inconsistent with both the PFs, previous CMA decisions and standard regulatory practice.

126 Overall, it appears that there is a risk that the CMA, based on the limited analysis in the working papers, may inappropriately reach an outcome that is not financeable for a small company such as Bristol Water. It is incumbent upon the CMA to demonstrate that it has considered Bristol Water's unique position as part of re-determining our price control. This should include further consultation on Bristol-specific issues to ensure we have an opportunity to comment on the CMA's position before the Final Report.

[37] Bristol Water Response to CMA Provisional Findings, paragraph 278.