iCON Infrastructure LLP

15 Golden Square
London, W1F 9JG
United Kingdom

27 January 2021

Competition and Markets Authority (the "**CMA**")
Water Redeterminations 2020 Panel

By email: waterdetermination2020@cma.gov.uk

Dear CMA,

Re: Water Redeterminations 2020: Working papers – Cost of Capital (the "Working Papers")

Thank you for the opportunity to respond to the Working Papers. We are writing to you in our capacity as a longstanding investor in the sector, which currently involves us advising the iCON Infrastructure family of institutional funds that own 80% of Bristol Water plc. This letter contains the views of iCON Infrastructure LLP and does not purport to represent any opinions of Bristol Water plc.

In general, we have been deeply concerned by, and sensitive to, positions taken by Ofwat in relation to Bristol Water during PR19, and now the CMA redetermination, that we have felt are contrary to settled regulatory positions from previous decisions and practice. In the context of this sensitivity, we had the following principal concerns when we reviewed the Working Papers:

1. They do not consider the position of Bristol Water which, as a small company, is different from the other appealing companies. In particular, the Working Papers do not work through the consequences of the potential revised positions on Bristol Water's specific redetermination.
2. The Working Papers contemplate substantial changes from the Provisional Findings, including in a number of ways which have specific effects on Bristol Water and without any disclosed consideration of potential implications (such as on financeability) for a company like Bristol Water.

We have chosen to make only a limited number of observations concerning how some of the contemplated changes to the CMA's views, which are outlined in the Working Papers, would have specific implications for smaller WoCs, and Bristol Water in particular. Company specific features need to be recognised and addressed. Witness, for example, the commentary and company specific additional allowances that Ofgem made in its RIIO-2 Final Determination for growing companies that are an order of magnitude larger than Bristol Water[1]. The commentary below is not comprehensive and it is intended to be complementary to other comments made by the appellant companies, including Bristol Water, in respect of the Working Papers.

1. General

When investing in Bristol Water, our funds relied on long-established regulatory precedent that small water only companies ("WoCs") would be compensated for having a higher cost of capital than the larger Water and Sewage Companies ("WaSCs"). <u>It is accepted, including by Ofwat, that a small company debt premium exists both on embedded debt and new debt</u>. We welcomed the CMA clarifying in your Provisional Findings, consistent with the CMA's PR14 redetermination for Bristol Water, that applying an arbitrary / subjective "customer benefits" requirement to establish the entitlement to the small company premium was flawed. In addition, it continues to be the case

[1] Refer Paras. 2.61-2.62 of Ofgem's "RIIO-2 Final Determinations – Finance Annex", 8 December 2020

that the higher exposure to operational and cost risks for smaller companies such as Bristol Water should be compensated with a small company equity premium and we look forward to the CMA confirming this, once again consistent with the PR14 redetermination for Bristol Water. We would hope that the position on these matters is settled "twice-and-for-all" in your specific redetermination for Bristol Water, respecting precedent and eliminating the risk of having to relitigate the issues again in respect of PR24.

In the course of the CMA's 2020 redeterminations, Ofwat has raised the new contention that Bristol Water is not a "small" water company and thus should not receive any small company premium. This was never raised as an issue by Ofwat during the PR19 process for Bristol Water. In fact, Ofwat relied on Bristol Water being a small company for elements of its PR19 determination[2]. The South Staffordshire Water group, which was granted a small company premium, has higher total allowed revenues over AMP7 and serves more customers over a larger service area than Bristol Water. Finally, Bristol Water's RCV in real terms will be roughly the same level as at March 2025 as it was at March 2015.

2. Selected Observations

(a) Embedded debt

The Provisional Findings assessment of embedded cost of debt premium of 10bp was based on a calibration by reference to a proposed cost of embedded debt for WaSCs. Should the CMA now revisit its analysis, as contemplated in the Working Papers, to reduce sector allowances for a notional WaSC benchmark, there would be a corresponding increase in the debt premium for a notional WoCs as a result of such recalibration. In its PR19 Final Determination, Ofwat allowed Portsmouth Water and South Staffordshire an uplift for a notional small company of 35bp on embedded debt. The artificiality of Ofwat's contention that Bristol Water is no longer a small company has been addressed above. Unfortunately, there is no commentary in the Working Papers to explain how this interdependence between benchmark and small company cost of debt premium may be considered and addressed in the context of changing WaSC benchmark.

(b) Availability and cost of new debt

In its PR19 Final Determination, Ofwat allowed Portsmouth Water and South Staffordshire an uplift for a notional small company of 25bp on new debt. [redacted] This is notwithstanding that, as shareholders, we have supported the deleveraging of Bristol Water to around the 60% notional level by March 2020 having not taken dividends from Bristol Water group since our funds' investment in 2016.

(c) Proportion of new debt

The assumed 20% ratio of embedded to new debt is not appropriate for WoCs, effectively discriminating against them with a lower overall cost of debt allowance <u>in substance</u> versus WaSCs because of their inability to access cheaper debt markets for the high relevant portion of new AMP7 debt assumed to be raised in a lower interest rate environment. Implicit in the assumption

[2] See, for example, Row 1 of Table A.1.5 at https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf.

of 20% average weighting of new debt over AMP7 is that c.40% of debt existing at the end of 2025 will have been raised during AMP7. This is simply not realistic for the WoCs, which don't have scale for frequent financing and need to manage refinancing risk and availability of funds carefully.

The above situation is compounded for Bristol Water which has a real RCV that is declining over AMP7. Assuming that it maintained 60% notional leverage, Bristol Water would experience a net repayment of debt during the period (which effect would be compounded by it having to come from existing cheaper, short term debt). In fact, the proposed 20% new debt share in combination with RCV decline implies that nearly 50% of Bristol Water's debt at the start of AMP7 would need to be refinanced during AMP7. Bristol Water's position is very different from the position facing larger WaSCs which have growing RCVs coupled with substantial and frequent issuance programmes. Ofwat's contention in Paragraph 4.42 of its response to CMA's Provisional Findings that share of new debt should take account to RCV growth is equally applicable to Bristol Water in reverse. In passing, it is noted that the Working Paper's (and Ofwat's) approach creates a perverse incentive for all companies to seek to grow RCV, so they can raise new cheaper debt in a lower interest rate environment thereby averaging total debt cost down.

(d) Debt benchmark

We disagree with the significant movement being considered by the CMA from the 20 year trailing average adopted in the CMA's Provisional Findings to a 15 year collapsing average (which would approximate mathematically to a c.12.5 year trailing average). The 15 year look-back period translates to 33.3% of existing debt at 2020 being refinanced during AMP7, which is not the case for WoCs generally. The overwhelming majority of bond debt within WoCs today was raised through Artesian or similar long-term bond programmes in the period 2002-2007 (in advance of the financial crisis), and only matures after 2030. It has been well debated and settled, including in the CMA's the PR14 Bristol Water redetermination, that this debt was raised both efficiently and for legitimate purposes at the time[3]. Notwithstanding, the Working Paper proposal would effectively leave this WoC debt stranded. In the above context, we are unclear of the importance placed by the CMA in its decision-making on current maturities (ie. look forward) for determining the appropriate look-back period[4].

We commend the Provisional Findings' objective approach to data selection and interpretation but are concerned that the "matching adjustments" muted[5], were a 20 year look-back period selected, seems to risk an approach whereby data that is not relevant to Bristol Water would be used to fit with an 'a priori' finding contained within the Working Paper. For example, WoCs do not have any EIB debt and cannot raise it:- Ofwat acknowledged this in PR09[6] and Bristol Water was unsuccessful in attempts to meet the EIB's requirements early in AMP6.

(e) Cost of equity

We agree with the CMA that negative asymmetry of outcomes from Ofwat's PR19 Final Determination needs to be addressed in the cost of equity. The phrase "aiming up" has become unnecessarily emotive during the course of the redetermination process given, as the CMA rightly points out, that its approach is consistent with long-standing precedent in relation to the exercise

[3] In Para. 70 of "Cost of Debt - Working Paper", it is stated that "Ofwat did not raise concerns about the use of non-operational debt at the time this debt was issued". In fact, executives in our firm who were investing in the sector in the period 2000-2005 would contend that Ofwat welcomed new capital from all sources to address the capital deficiencies which arose early in the millennium following PR99 and then the technology crash, and explicitly provided written consents for elements such as upstream loans.

[4] See Para. 78 of "Cost of Debt - Working Paper".

[5] Refer Para. 77 and Section 6 of "Cost of Debt - Working Paper".

[6] See p.132 of Ofwat's "Future water and sewerage charges 2010-15: final determinations".

of regulatory discretion (including that of Ofwat). We do not, however, believe that the contemplated choice (and now proposed lowering) of the point estimate adequately compensates for the implied risk and asymmetry for a company such as Bristol Water. The principle of considering and adjusting cost of capital allowances by reference to <u>expected</u> outcomes was dealt with by the CMA in its PR14 redetermination for Bristol Water.[7] As has been outlined elsewhere, Bristol Water would overspend the inadequate AMP7 cost allowances specified in Ofgem's PR19 Final Determination in order to achieve the proposed service levels. Further, even assuming that the CMA adjusts Bristol Water's costs allowances to an appropriate and efficient level, it is expected that net penalties would be incurred by Bristol Water over the course of AMP7 given the challenging ODI framework. Bristol Water's experience in the first year of AMP7 bears out this underperformance on costs and performance. Such issues are exacerbated for the WoCs which do not have the scale to cope with adverse cost developments or the potential to manage lower spend in the same way as WaSCs. For instance, we have seen the privately owned WoCs generally adopting lower leverage levels than the privately owned WaSCs in recent years as well as suffering lower (and more precarious) ratings from the ratings agencies coming out of Ofwat's PR19 Final Determination. This also has flow-on implications for decisions elsewhere, such as the appropriate notional leverage as well as the applicable iBOXX benchmark for WoCs specifically.[8]

(f) Financeability

Finally, we believe that any views on notional cost of capital parameters need to be considered in the context of the implications for actual financeability of Bristol Water specifically, having regard for the regulatory settlement in the round. In this context, we note the points made above regarding Bristol Water's leverage being in close proximity to the 60% notional level and such debt having been raised efficiently over time. In the absence of such testing and calibration by reference to the finance duty owed to Bristol Water, any choice of parameters is prone to risk and revision. We have deep concerns, albeit recognising that the CMA has not shared any revised views on small company cost of capital issues, that the proposed changes to the Provisional Findings have the potential to undermine Bristol Water's financeability.

* * * * * *

We hope this letter will be helpful for your deliberations on the subject matter. We would be happy to discuss its contents and any further matters with you.

Yours sincerely

iCON Infrastructure LLP

[7] See Para 10.11, pp.296-7 of CMA, "Bristol Water plc final determination, 6 October 2015 where the CMA was clear that the return required by the marginal investor is dependent on the generosity or otherwise of "other aspects of the price control determination, for example projections of totex". The CMA in 2015 "… made central projections of totex and other elements in the price control (which we interpret as expected values)."

[8] For example, see pp.134-135 Ofwat's "Future water and sewerage charges 2010-15: final determinations" where the notional gearing assumption for WoCs was assumed to be 5% lower than for WaSCs in the context of potential for "higher exposure to specific risks".