PR19 Redetermination

Bristol Water:

Final observations

3 February 2021

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Contents

1. Final observations

1 In this submission we provide our final observations for the CMA to take into account in its final redetermination. Although we have some final detailed comments that follow this section, it is important that recent submissions do not obscure the fundamental reasons why the Board of Bristol Water were faced with no choice but to seek this redetermination – a Final Determination from PR19 that was not financeable for a small water only company like Bristol Water. We therefore summarise the key grounds of our case below, setting out in each case our position on the CMA's proposed approach in its published Working Papers.

Cost of capital

2 Our redetermination case centred around the fact that Ofwat set the cost of capital too low to support efficient financing for Bristol Water as a small water only company (WoC). This was contrary to significant regulatory precedent from our previous references to the CMA in 2015 (CMA15) and the Competition Commission in 2010 (CC10), and robust evidence that a small WoC like Bristol Water faces higher debt financing costs. Ofwat's failure in the FD to apply a Company Specific Adjustment (CSA) uplift on the cost of debt, alongside the other errors, means we cannot expect to earn a reasonable rate of return on our efficient level of costs in the 2020-2025 period. **The evidence has been clear throughout this case. Based on its more recent response to the cost of capital working papers, Ofwat's main point appears to be that Bristol Water is no longer small. This argument does not hold up to any scrutiny.**

3 **Our case was that the overall cost of debt should be set based on a notional small WoC, with suitable cross-checks to our actual costs.** This requires consideration of the embedded cost of debt, cost of new debt and the appropriate ratio between the two for 2020-25. **The CMA should focus on the overall cost of debt for a small WoC, which is a minimum of 4.9%**[1] . Ofwat's final response to the cost of capital working papers focuses on only one of our small loans as evidence that contradicts this notional principle (Sun Life), without addressing the wider evidence on our actual costs. Ofwat's position is incorrect. For clarity, we provide final detailed evidence on this loan which the CMA will note disproves Ofwat's assertions about the cost of debt we face.

4 On the **cost of equity**, our case is that there is CMA precedent from 2015 that small WoCs required a higher cost of equity, and whilst we focused on the CSA on debt up to the PR19 draft determination (whilst presenting evidence on CSA on equity), this reflected Ofwat's PR19 process of the cost of capital being revisited for new market data at that point. We made it clear that the overall cost of equity for Bristol Water should consider a financeable determination package based on our plan debt costs, cost allowances and incentive package. The evidence for a CSA on the cost of equity is now stronger for this determination than it was in 2015, given the clear sector water service underperformance in AMP6 and the asymmetry in water service ODIs that is not diversifiable for investors in small WoCs. Including a CSA uplift on the cost of equity, a cost of equity for Bristol Water of c7.8% is fully justified.

[1] We set out the alternative overall cost of debt cross checks in the table on page 14 of our final response to the cost of capital working paper.

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Cost allowances

5 Our cost allowance issues are not about Ofwat's models at PR19, but how the modelling was applied by Ofwat. The CMA recognised some of the key factors related to this in the PFs (for instance the CMAs provisional decision not to go beyond an upper quartile benchmark, and to limit frontier shift to 1%), which has been subject to limited further debate. However, there are key cost allowance issues where the correct approach appears to be clear, but doubts as to the CMA's approach remain based on the recent working papers:

(a) **2019/20 cost data.** The evidence is incontrovertible that this data should be used. Use of 2019/20 cost data confirms our view of the service-cost relationship that featured in our Statement of Case, which was accepted in principle by the CMA in the PFs, and therefore using this data is more consistent with the development of the CMA's reasoning throughout the redetermination process. The data improves the reliability of the models, and the outcome is material to Bristol Water's cost allowances. **The final cost allowances should use 2019/20 cost data in accordance with good regulatory practice.**

(b) **Leakage**. The evidence is incontrovertible that companies with a lower level of leakage will have higher efficient base costs, and this is not reflected in the base cost models. The CMA should cross-check its final approach following RFI033 against our previous submissions and the range of adjustment methods we have presented. There is however no one correct approach, so considering the range of evidence for the appropriate size of adjustment is important. Our PF response proposed c£6m as the minimum estimate of an appropriate adjustment for Bristol Water.

(c) **C&RT water purchase costs.** This is a simple issue – a cost outside of the model which has been treated as an unmodelled cost in the past. The extension of timeframe of this case has eliminated any uncertainty as to the adjustment necessary - £9.9m as set out in our response to RFI028.

Balance of risk

6 **ODI issues** have received less prominence in the redetermination since the PFs, until Ofwat's recent suggestion of adjusting ODIs as an alternative to "aiming up" for asymmetry. **The specific and narrow issues we raised were correctly recognised in the PFs**. In the absence of further debate, we assume the CMA will maintain the PF position in support of the two narrow and specific ODI issues we raised, on Per Capita Consumption and mains repair ODI designs.

7 **Asymmetric totex sharing rates**. We welcome the CMAs recognition in the PFs that 45%:55% was more appropriate than the totex sharing rates in Ofwat's FD. We retain our original view, in particular given the uncertainty around base and enhancement cost allowance approaches in the CMAs more recent analysis, that our view that symmetric totex sharing at 50%:50%, as in 2015, has sound reasoning to support it.

8 **Gearing outperformance sharing mechanism.** We agree with the CMA PF conclusions, and the GOSM should not be applied in the final determination. Ofwat has not suggested an adequate alternative design. If there is an issue, it appears to be where company specific financial resilience is at risk and there is a need to stop that company's already high gearing from rising further in response to potential licence-driven dividend lock ups. This appears to be the

challenge that Jonson Cox was describing at the recent round table. As Ofwat acknowledge, it is not a challenge that is relevant to Bristol Water in this redetermination.

Financeability

9 The original PR19 Final Determination was clearly not financeable, a conclusion that the other issues in our case ultimately leads to. There is a clear risk that the CMA is distracted from this focus of our case by the range of individual, detailed and highly technical topics and discussions the panel has been presented with. The CMA must ultimately address the Finance Duty in a manner relevant and appropriate to Bristol Water. The PFs were clear about this principle, and the cost of capital working paper clearly includes data on an appropriate notional water company relevant to Bristol Water. We ask the CMA to use this data and conduct a thorough financeability assessment and the appropriate cross-checks.

10 If the CMA conclude, as is our case, that the additional cost of finance faced by small water only companies like Bristol Water is not a matter of timing or averaging, then financeability should be considered explicitly using a realistic overall cost of debt. This will provide the CMA with context for our other requests set out above. Ofwat's failure to focus on this, and subsequent obfuscation about what it considered did or did not constitute financeability / headroom testing in the Final Determination contributed to the need for this redetermination, irrespective of the other issues set out above.

Cost of the reference

11 For significant aspects of our case, the issues were covered by the CMA in its 2015 findings, including the small company premium precedent for Bristol Water. The CMA should have at the front of its considerations this perspective, and the narrow range of issues we raised. Our claims must have merit, given they are not in many aspects new to this redetermination. We do not consider it reasonable for our investors to pick up any of the cost of this reference. We have some observations based on Ofwat's cost recovery submission.

12 Ofwat states in its cost recovery submission that we raised a new cost claim on leakage for this redetermination. This is untrue. Our position on leakage has been consistent throughout our business plan, our response to Ofwat's Initial Assessment and our response to the Draft Determination. This position was confirmed by Ofwat's alternative leakage models used in the Final Determination, but not applied for Bristol Water (only for Anglian Water). This was an error, which should not be compounded with the cost of the reference.

13 Ofwat similarly continue to claim that our request for a CSA on the cost of equity is a new issue – but we have provided evidence that we raised this issue repeatedly, as we were concerned that Ofwat's lower cost of equity in its Final Determination would leave an inappropriate financeability challenge, which in the event it did. Given that the CMA 2015 determination allowed for a cost of equity CSA this issue should certainly not be considered "new".

14 Ofwat also asked for benchmarking of legal and consultancy costs – as a small company we do not have access to the scale of repeat business and lower Government rates that Ofwat do, or the same scale of relevant internal resources. On the CSA and in particular the customer benefits test, the CMA should have in mind how much of our analysis is driven by Ofwat's methodology and its application, where this has a particular impact on Bristol Water.

Closing comments

15 The CMA has asked us during this case what would happen if we were left to cope with Ofwat's FD. Of course this has now happened for two years and the impact is no return to investors, a rating position far below notional assumptions at risk of further downgrade, and avoiding any investment that was not essential in the short term given both cost and ODI underperformance pressures. A final determination from the CMA that addresses the points we summarise with these final observations will allow Bristol Water to celebrate its 175th birthday and beyond with its employees, investors, customers and stakeholders confident of Bristol Water's ability to continue to provide its excellent, local services as a viable, independent company.

16 At the same time the CMA should make a clear statement to Ofwat that it should not place Bristol Water in the same position for a fourth consecutive price review, PR24. The CMA has observed a chasm between companies, stakeholders and national regulation and consumer representation in this process that should not be ignored given the importance of local water services. The CMA should not be silent, but rather should reflect and amplify what it has heard during this reference and help to ensure that local needs, rather than just national economic regulation, is given sufficient weight in future regulatory decisions.

17 This has been a challenging process for all involved at an unprecedented time. The CMA has faced an unenviable task with four disputing companies raising a diverse range of issues, the wide ranging arguments promoted by Ofwat and the extensive third party interest that arose. Most of this had little relevance, if any, to the Bristol Water redetermination. Our Statement of Case was specific and smaller in scope.

18 With good reasons, we have raised concerns that the exceptional nature of this process, following Ofwat's reaction to the Provisional Findings (PFs), has affected the focus on our specific issues in the subsequent reconsultation process. On the cost of capital the short round table session helped to clarify some of the key issues, helpfully enabling both ourselves and Ofwat to focus on the specific evidence applying to Bristol Water. We hope our summary of the key issues from our Statement of Case assists the CMA in considering the context of the range of our issues and evidence before the final determination.

2. Cost of debt

19 We have some final observations following Ofwat's final cost of capital response on 27 January.

20 Ofwat asks the CMA to focus on the objective and interest of consumers.

"However, there is one over-arching background perspective which we urge the CMA to keep continuously in mind: the objective and interests of consumers. At this relatively late stage in the redetermination process, the submissions made to the CMA have increasingly been dominated by the well-resourced company and investor voice, on occasion to the exclusion of other perspectives."

21 For Bristol Water the customer and local stakeholder support for all the points we raise is clear, including from the independent submission from the Bristol Water Challenge Panel. Ofwat's characterisation of "well-resourced" voices excluding other perspectives does not reflect reality. We note iCON Infrastructure, the majority shareholder in Bristol Water, has reserved its comments for this late stage of the process and only in response to the approach taken by Ofwat towards small companies and their financing.

22 Cutting through this Ofwat position, there appears to be no dispute left on the appropriate cost of debt for Bristol Water. At the very least for our current circumstances and the period 2020-25, Ofwat has presented the CMA with no useful information to contradict our position, and by implication our analysis of the CMAs working paper on notional WoCs / Bristol Water actual cost of debt cross-checks.

23 We therefore do not comment on Ofwat's detailed final response on the industry cost of capital issues. We note that Ofwat recognise that commitment to a longer-term benchmark provides stability in the regulatory regime, with the risk that this does not share benefits with customers where companies beat the benchmark**.** We agree – our requests on the cost of capital have always been cross checked in this way. For a notional WoC, no company beats the benchmark and there is no benefit to share with customers.

24 **This lack of outperformance for a notional WoC, actual in AMP6 or forecast for AMP7, applies to the overall cost of debt and cost of equity (including water service asymmetry).** We expand on this further below.

CSA on embedded debt

25 Ofwat continue to claim that Bristol Water has somehow ceased to be small, now described as "*the WoC one size down from Affinity Water*". We have dealt with this in paragraph 23 of our final response on the cost of capital working paper on 27 January – the data speaks for itself. **For financing purposes, Bristol Water is a small company and is likely to remain so.**

26 We welcome Ofwat's recognition that based on an index-led sector allowance, there should be a higher cost of debt for a notional WoC like Bristol Water[2].

[2] Ofwat final response to the cost of capital papers, paragraph 4.4

27 We also welcome Ofwat's recognition that WoCs have not benefited from EIB debt.

"Hybrid approaches: It would be possible to apply a 'matching adjustment' to consider the broader issuance of small WoCs as well as the wider sector. We agree that WoCs have not benefited from EIB debt and so this should not feature in any adjustment. As evidenced in the 2020 APRs, small companies do make use of floating rate debt and so it would be appropriate to reflect this."

28 Although Ofwat believe in principle that small companies make use of floating rate debt and this could be reflected in a "hybrid" approach, the evidence we have presented shows this would be larger than the upwards adjustment based on an index-led sector approach plus 35bps as Ofwat contend (4.85%), given that the CMA working paper shows a notional WoC starting point of 5.3% that includes current floating rate debt, a positive matching adjustment of c40bps. This is clearly shown in table 1 of the CMA cost of debt working paper.

29 Therefore Ofwat appears to suggest a hybrid approach for a notional WoC that considers 35bps above a 4.5% index-linked benchmark (i.e. 4.85%), with some consideration of the 5.3% once floating rate debt is included (a positive matching adjustment).

30 The explanation for a higher cost of floating rate financing for WoCs compared to WaSC is the reason why the CMA must assume a higher cost of new debt for WoCs. It relates to the availability of sources of financing and the higher cost of smaller tranches. For smaller WoCs in particular there is a reliance on Revolving Credit Facilities (RCFs), because of the need for liquidity, which comes at a higher cost. Looking at individual instrument evidence (irrespective of Ofwat's incorrect assertions on Sun Life which we address further below) does not provide a full matching adjustment picture, unless the whole cost of debt evidence is considered. For instance, RCFs have both interest due on drawn funds, and facility fees on undrawn facilities. So there is a cost of carry directly associated with this, which is higher for small WoCs than companies that have larger loans and can achieve liquidity through drawdown flexibility without a higher cost of carry/liquidity cost.

31 Ofwat does not present alternative numbers to the CMA working paper for a notional WoC. Given the general agreement therefore, we think the cross-check on the overall cost of debt that we present in paragraph 46 of our final response to the cost of capital working paper sets out how the CMA should consider the notional WoC overall cost of debt logically. **The minimum overall cost of debt, justified by the evidence for a notional WoC, is 4.9%, and could be as high as 5.3%.**

CSA on new debt

32 Ofwat continue to reference the small £25m Sun Life bank loan *"and its 19bps implied discount to the iBoxx A/BBB after controlling for tenor and credit rating is compelling evidence that the company does not face an ongoing debt issuance premium"*[3] as the sole reason not to allow Bristol Water a CSA on new debt.

[3] Ofwat final response to cost of capital papers, paragraph 4.5

33 **The Sun Life bilateral loan evidences a premium debt cost of at least 30bps paid by Bristol Water relative to comparable WaSC debt issued contemporaneously in the relevant market.**

34 We have dealt with the pricing of Sun Life (and the ING financing) at length, demonstrating that Ofwat has no basis whatsoever for repeating their view that this supposed discount can be "implied"[4]. Ofwat has not commented on our factual analysis.

35 In our view, we have understated the evidence on the size of CSA on new debt. The 15bps we calculated is the minimum supported by the evidence, and the 25bps Ofwat used at the FD and the 40bps implied through the "matching adjustment" evidence discussed above are alternative approaches the CMA should consider. The CMA should consider this in reviewing the appropriate overall cost of debt for a notional WoC.

Sun Life

36 Given Ofwat has raised Sun Life again in its latest submission, we illustrate further that this debt supports a notional WoC uplift to the cost of new debt (and embedded debt). ✂

37 At the time the USPP market was priced competitively, with US credit spreads (as reflected in USD iBoxx corporate indices) having reached 10 year lows in the fourth quarter of 2017. The demand for GBP loans in the USPP market was in part a consequence of the interest rate differential then present between the UK and the US which meant that North American lenders could benefit from a significant yield pick-up (of c.1.6% per annum in USD terms) when they converted GBP loan exposure to USD through cross currency swaps.

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[4] Bristol Water (2020), Response to Provisional Findings, section 12.2

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43 Absolute and relative market movements also mean that the pricing of the Sun Life loan is not representative of Bristol Water's cost of raising new debt in the future. Bristol Water's timing was fortuitous as credit spreads were at their lowest around the time that the margin was settled with Sun Life, both on a historic and prospective basis. Actual USPP issuance data over the relevant period to which we have access, which is presented in the table below, also bears this out:

Date	Borrower	Rating	Amount (GBP million)	Tenor (years)	Spread (bp)
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂
✂	✂	✂	✂	✂	✂

Source: Bristol Water, ✂

44 **The evidence on Sun Life shows a clear premium to the most relevant WaSC benchmark in excess of 30bps. In this context, the CMA should not place reliance on Ofwat's interpretation of the Sun Life loan**.

Overall cost of debt

45 Ofwat state[5] *"We accept that Bristol Water may have historically faced an issuance premium to the iBoxx A/BBB as a smaller company. This is however much less clear about its recent issuance (e.g. its Sun Life Loan) which suggests a discount to the iBoxx when tenor is controlled for. The implications of this are that the blended average of Bristol Water's historic and recent issuance is liable to demonstrate a lower weighted-average small company premium than the average small company premium estimated on the whole span of historical WoC bond data (which is largely concentrated in the pre-2010 period). Over time this might reasonably be expected to tend to zero. We would welcome the CMA's consideration of the question of at what point a small size uplift ceases to be appropriate in its final determination."*

46 The evidence on WoC debt costs, including for Sun Life, supports a conservative overall cost of debt for a notional WoC of between 4.9% and 5.1%, as set out in paragraph 46 of our final response to the cost of capital working paper. If the CMA are to carry out an actual company cross check in determining the cost of debt for Bristol Water, this must be on the overall cost of debt as set out in paragraph 46 of our final response to the CMA's cost of capital working papers.

47 There is no evidence to support Ofwat's contention that a small company premium for a notional WoC should tend to zero over time. Therefore the CMA does not need to speculate on future WoC debt costs in the way Ofwat suggests.

3. Cost of equity

48 Ofwat raise a number of issues on the cost of equity uplift. None of these points are new and therefore we do not repeat points here which are addressed in our initial and final response to the CMA working papers.

49 Ofwat raise one issue on aiming up and the cost of equity more generally. *"Finally, and importantly, the logic of the CAPM is that investors should only be rewarded through the allowed return for non-diversifiable risk. ODIs are in principle a risk that is diversifiable by investors. Wright & Mason reference that adjusting the allowed return for perceived asymmetry in expected performance is not only a blunt instrument, but also one that is inappropriate. We submit that should the CMA continue to perceive there is asymmetry to underperformance, adjustments should be made at the source of that expected underperformance, rather than to the allowed return."*[6]

50 We do not agree with Ofwat that the risks are diversifiable. For example, a water sector investor cannot diversify DWI Compliance Risk Index, third party supply interruptions or the correlation of weather risks in a range of ODIs. As we have demonstrated, the risks are specific to asymmetric and penalty only ODIs on the water service, exacerbated by AMP7 improvement targets. Investors in WoCs cannot diversify these systematic risks from Ofwat's approach to the regulatory framework.

[5] Ofwat final response to cost of paragraph working papers, paragraph 4.3
[6] Ofwat final response to cost of capital working papers, paragraph 2.31

4. Leakage

51 Leakage base and enhancement costs are an area where there should be little remaining dispute given Bristol Water's low level of existing leakage and low level of enhancement cost. However in our response on the leakage working paper we disagreed that a "bottom up" assessment challenge should be applied to Bristol Water, as neither the CMA or Ofwat presented any evidence of having carried out such an assessment.

52 Ofwat raised two issues in its response to bottom up assessments[7]

(a) *"The CMA's approach does not take into account that some of these costs contribute to improving performance on other performance commitments."* **This does not apply to Bristol Water. The cost of maintaining our existing smart network monitoring is within base costs. The Isle Utilities report provides suitable evidence.**

(b) *"Where companies have provided poor or minimal justification for their assumptions or for their choice of approaches and processes used to build up activity and cost profiles, this should be reflected in the extent of the cost challenge provided by the CMA."* **This does not apply to Bristol Water. The assumptions are fully justified, and the Isle Utilities report provides evidence of leading international leakage performance, and that other options would be more expensive.**

53 Ofwat extended its logic to base funding[8] *"For example, where an efficiency challenge or a bottom-up challenge is applied to an enhancement funding request, the same logic can be extended to the base funding requests, as these are very likely to have been developed using similar data and assumptions by the company in question."* **In our case the costs were developed on a totex basis. Given the efficient approach to leakage enhancement, Ofwat should have accepted our base leakage allowance claim that was on this very basis in our response to the Draft Determination.** Ofwat instead did not assess this case at the time. Ofwat's logic therefore supports a base leakage adjustment as set out in our response to the Provisional Findings (£6.2m).

54 Having reviewed Ofwat's response to RFI033, we could not replicate its forecast of 2024-25 upper quartile / median leakage performance. We note the CMA has requested this data from Ofwat, but we have not been able to consider this given the final deadline for this submission. As our 21% reduction in leakage is the highest amongst the companies for AMP7, Ofwat's calculation does not make intuitive sense. Our own calculations consistent with our response to the PFs[9] show Bristol Water 33% below the geometric mean upper quartile and 44% below the median for 2024/25. Given this uncertainty, the CMA should prefer to use 2019/20 actual data rather than using forecast performance. As we stated in response to RFI033, relying on forecast performance would be unusual regulatory practice as it carries the risk that companies may not deliver the targeted performance levels or this results in a higher base cost.

[7] Ofwat response to leakage working paper, paragraph 2.13
[8] Ofwat response to leakage working paper, paragraph 2.15
[9] BW442 source file

	Three year avearge to 2019/20 Leakage l per prop	Three year avearge to 2019/20 leakage m3 per km	Three year average to 2019/20 Geometric mean	Rank	Three year avg to 24/25 l/prop/d	Three year avg to 24/25 m3/km/day	Three year average to 24/25 geometric mean
BRL	75.21	5.94	21.13	2	56.1	4.6	16.05
ANH	87.44	5.03	20.98	1	68.1	4.1	16.68
YKY	135.09	9.86	36.49	14	110.6	8.2	30.19
NES	98.45	7.68	27.50	9	81.8	6.5	23.12
AFW	124.79	11.28	37.52	15	94.6	8.9	29.02
WSX	119.58	6.19	27.22	7	98.9	5.3	22.89
WSH	118.69	6.19	27.10	6	100.0	5.3	23.04
SVE	116.83	9.06	32.54	12	97.1	7.7	27.32
SRN	80.13	7.17	23.97	3	71.8	6.0	20.76
SEW	93.17	6.49	24.58	4	80.4	5.6	21.30
SES	86.03	7.20	24.89	5	72.2	6.2	21.23
TMS	159.99	19.65	56.06	17	121.4	15.3	43.04
UU	133.65	10.59	37.62	16	115.6	9.3	32.84
SSC	114.52	9.91	33.69	13	91.5	8.1	27.15
HDD	134.52	5.81	27.95	10	124.3	4.9	24.80
SWB	117.90	6.79	28.29	11	95.9	5.7	23.37
PRT	88.36	8.47	27.36	8	72.3	7.1	22.60
UQ	**88.36**	**6.19**	**24.89**		**72.32**	**5.31**	**21.30**
median	**116.83**	**7.20**	**27.50**		**94.63**	**6.24**	**23.12**
mean	**110.84**	**8.43**	**30.29**		**91.34**	**6.99**	**25.02**
BRL % gap UQ	**-17%**	**-4%**	**-18%**		**-29%**	**-16%**	**-33%**
BRL % gap median	**-55%**	**-21%**	**-30%**		**-69%**	**-36%**	**-44%**
Leakage Base cost (£m)	**20.69**						
	base						
Value to UQ (£m)	**£3.6**	**£0.9**	**£3.7**		**£6.0**	**£3.2**	**£6.8**
Value to median (£m)	**£11.4**	**£4.4**	**£6.2**		**£14.2**	**£7.4**	**£9.1**

55 Ofwat continues to include vague and non-specific references to Bristol Water in its responses. We have already dealt with why the Ofwat suggestion of a 5% efficiency challenge was inappropriate, and less than the efficiency challenge already included in our plan, throughout our submissions (e.g. section 11 of our Statement of Case, our responses to RFI018a and RFI033, and our response to the leakage working paper).

5. Final financial modelling

56 We provided guidance in our 11 January Financial Modelling response, on the approach to the financial modelling we believe the CMA should undertake having reached its final decisions. Key points we raised were:

(a) The correct K factors should be used, consistent with Ofwat's PR19 Final Determination

(b) The CMA should check that notional ratios (for Bristol Water alternative AICR is the tightest) when profiling revenue, ensuring that this is above 1.5x each year as a minimum. In doing this, having fixed year 1 and year 2 revenue in line with the Final Determination, the CMA should profile revenues such that year 3 to 5 have the same bill in real CPIH terms to limit a step change issues in bills for 2025/26, assuming this profile also meets the minimum AICR level.

(c) Having fixed bills for year 3 to 5 in real terms, the CMA should then apply the blind year adjustment K factors over year 2 to 5 (as this is not notional and is post-financeability).

(d) The CMA should then apply any redetermination cost recovery as a revenue allowance in year 3 (2022-23). We explain why this is the correct financial modelling approach further below.

57 We welcome Ofwat's confirmation that no totex sharing should be applied to any recovery of the cost of the redetermination incurred by Bristol Water, including our share of the CMAs costs, that the CMA include as part of its Final Determination.

58 We disagree with Ofwat suggestion that this should be applied through amending cost allowances. In 2015 the CMA applied the cost recovery allowed to Bristol Water as a revenue allowance[10]. It is technically correct to apply this as a post financeability revenue allowance, as the cost recovery should not affect the assessment of notional financeability.

6. Annex

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[10] CMA (2015): A reference under section 12(3)(a) of the Water Industry Act 1991: Report, paragraph 12.15

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