iCON Infrastructure LLP

15 Golden Square
London, W1F 9JG
United Kingdom

3 February 2021

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

By email: waterdetermination2020@cma.gov.uk

Dear CMA,

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

We are writing to supplement our earlier submission in relation to the Working Papers dated 27 January 2021 with a view to addressing a number of assertions contained in Ofwat's final response to the Working Papers, also dated 27 January 2021 (the "**Ofwat Final Response**"). As previously, this letter contains the views of iCON Infrastructure LLP and does not purport to represent any opinions of Bristol Water plc.

Small Company

The Ofwat Final Response continues to make the novel contention that Bristol Water is not a small company, selectively quoting statistics and implying some relevance to the tagline that Bristol Water is now "the WoC one size down from Affinity Water". In this context, we have attached a more comprehensive set of size measures as an Appendix. This shows that South Staffordshire Water, which received a CSA in PR19, is actually a larger company than Bristol Water on all but one of the measures shown and Affinity Water is significantly larger. We also note that Affinity Water's largest constituent company, Three Valleys Water, received a CSA in previous price controls when it was significantly larger than Bristol Water.

Premium on Cost of New Debt

As per our 27 January 2021 letter, we believe that Bristol Water should be awarded at least a 25bp premium on new debt over the relevant WaSC benchmark to be, at a minimum, consistent with:- (a) what was awarded to South Staffordshire Water and Portsmouth Water in PR19, and (b) with Bristol Water's Statement of Case. In the Ofwat Final Response, it is implied that Bristol Water is requesting a 15bps cost of new debt supplement. The 15bp referenced, however, was a minimum, "conservative estimate" based on the Provisional Findings' methodology, which the Working Papers are now contemplating changing.

The Ofwat Final Response appears then to rely exclusively and repeatedly on a flawed interpretation of the Sun Life bilateral loan to contend that Bristol Water should not be entitled to a CSA on the cost of new debt going forward. In doing so, there are echoes of the inaccuracies in analysis contained in paragraph 9.483 of the Provisional Findings. iCON Infrastructure LLP was heavily involved supporting Bristol Water's 2018 financing activity so can bring important market context to the discussion.

First, the Sun Life bilateral loan is not representative of small company debt costs for AMP7 and beyond, for reasons including:-

(1) it is a small, once-off, bespoke loan that was raised bilaterally in the institutional market for US private placements ("USPPs") – it is incorrect to describe it as a local market "bank" financing;

(2) it is a point in time raising which benefited from unusually favourable conditions for GBP issuers at that specific time in the USPP market, where access and pricing can and does change materially over time;

(3) Bristol Water and other WoCs' sizes, debt structures and credit ratings prevent them from participating in the mainstream USPP market and raising viable / meaningful quanta of USPP-style debt (as some WaSCs do) – WoCs thus require (uncertain) engagement from a distinctive type of North American institutional lender willing to lend a relatively small quantum on a bilateral basis into that WoC's existing debt structure having regard to USD iBoxx pricing; and

(4) Bristol Water and other WoCs have limited ability and appetite to take USD (or CAD, if appropriate) cross currency / foreign exchange swap risk that typically forms a part of such financings.

[redacted]

The above discussion emphasises the need to examine the full facts and circumstances in which specific debt is raised (and to undertake comparisons on a like-for-like basis), especially when trying to use actual, individual instruments to inform a notional, wholistic approach. For example, paragraph 9.4.83 of the Provisional Findings mistakenly compares the Sun Life bilateral loan cost to the average 10+ A/BBB £ iBoxx index value over the whole of 2018 without accounting for the market (e.g. USPP), tenor, credit, actual timing of raising in 2018 (during which spreads in the USPP market as reflected by USD iBoxx varied materially) or its position in Bristol Water's overall debt structure. [redacted] Then, in order to benchmark this all-in-rate correctly against relevant WaSC benchmarks, one would have to compare it against appropriate indices of comparable tenor, credit, etc as well as market information in relation to contemporaneous WaSC raisings of a similar nature.

Proportion of New Debt

The large WaSCs have significantly greater ability to manage size, tenor and frequency of issuance within their large (and growing) debt portfolios over time. In comparison, WoCs are compelled to run a small portfolio of debt with a more bar-bell profile, balancing individual long term bonds with small shorter tenor facilities to manage average portfolio duration and refinancing risk. Ofgem's RIIO-2 final determination recognised the issues raised by company size for debt maturity profile in relation to companies that were significantly larger than the WoCs, and provided additional compensation.

In this context, it positively discriminates against WoCs versus WaSCs (given the different allowances for embedded and new debt cost) to assume (a) that WoCs refinance 33.3% of starting debt in every AMP, as implied by the 15 year collapsing average; and (b) roughly 40% of total debt at the end of an AMP was raised during the AMP, as implied by the 20% new debt proportion. It is noted that even Bristol Water's specific refinancing exercise in 2018, which was large by its standards and straddles three AMPs, refinanced only £75m of drawn debt (or 23% of the total drawn at the time) alongside providing a new undrawn £50m bank liquidity facility to take the company well into AMP7. Bristol Water itself will be particularly disadvantaged by this discriminating feature during AMP7, particularly in relation to financeability, because of its falling real RCV and debt structure.

Premium on Cost of Equity

The reason cited first and foremost in the Ofwat Final Response for not granting Bristol Water's request for a small company equity premium appears to be that Bristol Water did not request it until after the draft determination, and then apparently Ofwat chose to perceive the request to be in an insufficiently formal form. We do not believe this reason to be either valid or consistent with the approach taken to others. South Staffordshire Water omitted any request for a small company premium until <u>after</u> its PR19 draft determination, which was nevertheless granted. It is entirely appropriate that, having seen the balance of risk and return of the PR19 draft determination 'in the round', Bristol Water made the assessment that a small company equity premium would be justified as it had been in AMP6. Contrary to the implication in Ofwat's Final Response, the request for a small company equity premium was made by the company, it was discussed in the one presentation to Ofwat that was permitted Bristol Water between the draft and final determinations (which a representative from iCON Infrastructure LLP attended) and the request for Ofwat to include one in its final determination of cost of capital was sufficiently clear for the final determination to contain specific commentary on the subject including reasons for rejection of the request[1].

As regards merits, we note that the additional assertions raised in the Ofwat Final Response are not new having been thoroughly worked through by the CMA in Bristol Water's PR14 redetermination, in which a small company equity premium was granted, and have been strengthened by the risk/return framework and balance for WoCs specifically implied by the proposed regulatory settlement.

* * * * * *

We hope that this supplemental letter helps to provide further context supporting the subject matter of our 27 January 2021 letter. We would be happy to discuss its contents and any further matters with you.

Yours sincerely

iCON Infrastructure LLP

[1] Ofwat (2019), Final Determination, Allowed return on capital technical appendix, Annex 1: Company-specific adjustments to the cost of capital, pp. 96-97.

Appendix – Various Measures of Company Size

Company:	Bristol Water	South Staffordshire Water	Affinity Water
Key operating statistics:			
Population served	1,227,036	1,734,649	3,777,998
Service area (sq km)	2,367	2,672	4,515
Total connections	545,956	743,640	1,525,345
Water supplied (Ml/day)	271	388	926
Mains length (km)	6,875	8,580	16,789
# of water treatment works	16	40	101
# of water sources	25	44	122
Allowed revenue (17/18 average prices):			
AMP4	588	628	1,720
AMP5	634	654	1,651
AMP6	593	613	1,569
AMP7	553	618	1,459
RCV (17/18 year end prices):			
2005	329	325	1,051
2010	353	347	1,128
2015	459	353	1,112
2020	526	372	1,165
2025 (Forecast)	514	428	1,454

Notes:

(1) Sources: Ofwat, companies' annual reports, companies' annual performance reports and CMA.

(2) In figures for AMPs 4-5, Affinity Water comprises Three Valley's Water, Tendring Hundred and Folkestone & Dover Water (which were part of the same group throughout the period) and South Staffordshire Water comprises South Staffordshire Water and Cambridge Water (which merged in 2013).

(3) Allowed revenue figures for AMP4, AMP5 and AMP6 include non-household retail whereas this does not form a part of AMP7 allowed revenue figures.