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By email: PR19@ofwat.gsi.gov.uk

30 August 2019

Dear Rachel,

Re: PR19 draft determinations (the "DD")

I am writing to you to make representations in respect of the DD consultation document released on 18 July 2019. This letter has been provided from our perspective as a shareholder in the water sector, and specifically in Bristol Water plc ("**Bristol Water**", or the "**Company**"), in respect of which the infrastructure funds that our group advises and manages beneficially own 80% of the ordinary shares.

In the short space of time since iCON Infrastructure became a shareholder in Bristol Water, there have been numerous important achievements, including:- Bristol Water's board refreshed with strong representatives; a new management team installed; governance arrangements simplified and aligned with customers' interests; substantial deleveraging achieved (through suspension of group dividends to shareholders); business reporting, transparency and assurance standards materially improved; the primacy of customers' interests reinforced (as evidenced by the leading customer and stakeholders' engagement in Bristol Water's strategy formulation and business planning processes); regulatory engagement and cooperation enhanced; effective asset management strategy, processes and practices implemented; operational performance stepped up with a solid trajectory for the future; and consolidation of Bristol Water's position of trust in the local community (through, *inter alia*, its ambitious and widely supported business plan and its social contract initiative). As a shareholder, we are proud of Bristol Water's transformation to date but we, together with the Company's board and management, also firmly believe that the job is never done.

In this context, our reaction to the DD proposals for Bristol Water is one of deep disappointment coupled with concern as to where we may be heading over coming months. The evolving methodology, which has progressively targeted the reduction of revenues and increase of risk, has particularly impacted Bristol Water as well as its cohort of smaller water only companies, which we firmly believe are critical to the sector's diversity and dynamism as well as highly valued by their customers and local community.

We acknowledge that the price control process is only partly complete. Accordingly, our hope and expectation is that the Company and we can work together with you in good faith in the time remaining before the PR19 final determination to achieve a sustainable outcome for Bristol Water over AMP7 that serves customers' interests and reflects a fair but challenging balance of ambition, risk and return.

The Company will be separately making comprehensive representations in response to the DD consultation but we felt that it was necessary in the circumstances to highlight below three particular areas of concern.

1. Fundamentally inadequate cost of capital for Bristol Water

The proposed headline cost of capital would barely cover Bristol Water's actual debt service cost, thereby providing for a *de minimis* (and very likely no) potential return on equity through AMP7. Specifically:

- Approximately 50% of BW's Regulatory Capital Value ("**RCV**") is represented by efficiently raised, long-term bonds that have an aggregate real cost of 3.3% per annum (in RPI terms). Servicing these bonds alone accounts for 1.6% out of the proposed WACC of 2.1%, with Ofwat's signalling of potential further reductions in WACC of up to 40bp emphasising the jeopardy of the approach. There is little residual for servicing the remaining 50% balance of the Company's debt and equity even ignoring the effect of efficiency and incentives. The recoverability of Bristol Water's efficiently incurred, long-term debt cost as a company specific adjustment has previously been opined upon multiple times by the Competition & Markets Authority and its predecessors (the "**CMA**") in earlier price controls.

- The combination of improvements in service levels, the reward/penalty regime and efficiency targets all render under-recovery of published allowed returns almost certain. In Bristol Water's case, any underperformance translates into a threat to its ability to service debt given the absence of any equity buffer in the proposed cost of capital allowance. Actual debt service ratios (per Moody's basis) skirt 1.00x under the DD proposal for the Company and fall below 1.00x for AMP7 (in some cases, well below) for numerous realistic scenarios given the scope of demands and extent of risk implicit in the DD. Further, undiversifiable equity risks in the methodology are not compensated in the DD's cost of equity methodology, compounding statistical and other anomalies that we and others have raised.

- As previously raised, the assumption that 20% of Bristol Water's debt is refinanced in AMP7 penalises Bristol Water (alongside other smaller water only companies that do not have constantly revolving debt programmes). Bristol Water's real RCV declines over AMP7 and over 70% of its debt comprises long-term bonds maturing from 2032 onward. As a consequence, we would expect Bristol Water to have to retire rather than raise new debt over AMP7, with such flexibility only existing for Bristol Water's cheaper, short term debt (thereby compounding the issues highlighted above).

- Bristol Water was highlighted, we believe unfairly and to its reputational detriment, as a Company that has refused to agree with Ofwat's leverage sharing mechanism, notwithstanding the Company leading position as an early adopter of the principle and mechanics. The Company's approach to preference shares as equity was entirely consistent with reporting practices as well as precedent (based on views of both Ofwat and the CMA in the 2015 process).

In summary, maintenance of a comfortable investment grade rating could necessitate significant equity injections from shareholders over AMP7 amounting to more than £50 million. This would be highly problematic in the context of the absence of any return on such equity and a febrile political environment. This position also ignores that Bristol Water has already taken early, proactive steps during AMP6 to reduce its debt to around the prescribed notional leverage level well in advance of PR19 and other companies.

2. Overly ambitious, unbalanced and excessively penal Outcome Delivery Incentive ("ODI") regime

The Company set ambitious and challenging targets for outcomes guided by deep, unprecedented consultation with its customers and other stakeholders.

Unfortunately, Ofwat's methodology as it has evolved has increasingly prejudiced Bristol Water at each stage of the PR19 process. An example is the application of industry-wide, mandated improvements to areas where Bristol Water is a leading sector performer today, for example leakage, water quality and voids. This means Bristol Water receives only marginal benefit from its existing position and, in areas such as these, suffers a higher substantive hurdle and larger level of exposure than would apply to others.

Individually, the ambition in the DD targets and the asymmetric nature of the rewards/penalty structure are problematic. Collectively, the efficacy of requiring top quartile targeting across all metrics in the real world and the effective automatic application of heavy penalties arising therefrom are issues that we have previously questioned. It is not clear that the cumulative effect and interdependencies of parameters has been fully understood, including consideration in conjunction with efficiency targets. By way of example, is a near top quartile target for a mains bursts output appropriate for an older network, and how should such a target interact with asset management plans and targets for leakage and supply interruptions (which are the outcomes that our customers have indicated matter most to them)? Further, how do incentives on customer contacts regarding drinking water conflict or complement incentives regarding supply interruptions and mains repairs, and how do proposed DD targets marry with the priorities of the Drinking Water Inspectorate? It is noteworthy that the water supply sector has on average suffered net penalties thus far in AMP6, and this in the context of an ODI regime which the current DD proposals go well (and unrealistically) far beyond.

As a result, for example, Bristol Water finds itself in the curious and troubling position where the DD contemplates that it would have the most penal P10 ODI bound of all water companies, along with an excessive maximum ODI penalty exposure. The DD states a figure of negative 3.5% for Bristol Water's P10 ODI bound but the Company believes the correct figure to be materially larger at negative 4.6%. The Company estimates its maximum ODI downside to be c.12% (and that is after capping potential void penalties which otherwise would have a theoretical upper limit of c.£80 million per annum). This intimates the scope for viability-jeopardising, individual ODI penalties in several areas of the DD, in some cases ones that did not emerge from Bristol Water's customer engagement as high priorities. It is also no surprise given the above that Bristol Water's overall RORE ranges of outcomes are very wide, a situation compounded by the asymmetric, negatively biased probability distribution of potential outcomes.

3. Insufficiently tailored cost assessments yielding unrealistic efficiency targets

The top down, industry wide approach to costs as implemented in the DD fails to account appropriately for the important specific characteristics of individual water companies and their plans, resulting in substantive unfairness in outcomes. The inadequacies of the approach, especially insofar as it applies to the smaller water companies, are illustrated by the efficiency targets for Bristol Water on the one hand and the high efficiency attributed to other companies (which are recognised as having more favourable natural attributes).

A flavour of concerns follows:

- Bristol Water is expected to deliver the highest (>20%) total cost reduction and the second highest base expenditure reduction versus its historical costs of all the water companies. This merits deep investigation and understanding, especially given the step change in costs that has been achieved by the Company over the course of AMP6. The Company undertook a detailed and comprehensively consulted on (as well as assured) analysis of its efficiency position, special cost factors and considerations, which it has outlined in its plan and various responses. An example is Bristol Water's specific additional canal cost, which was accepted by Ofwat in its IAP assessment but then surprisingly reversed its position in the DD.

- Bristol Water adopted a fully totex-based approach to business planning. As a result, the Company's proposed enhancement expenditure equated to c.7% of its totex, the lowest proportion of all water companies. This approach would appear to have penalised the Company both in terms of efficiency modelling outcomes as well as in its ability to achieve the theorised level of expected future productivity improvements. Enhancement spend has historically been, and can be expected to continue to be, a key potential source of the efficiencies of other companies. This further compounds broader issues caused by the adoption of highly contentious and questionable industry efficiency targets.

- The totex assessment formed part of a comprehensively assured, holistic plan comprising, *inter alia*, calibration of the ODI package, transformation programme and asset management plan, which were all guided by customer and stakeholder engagement. The proposed efficiency targets in Bristol Water's DD threaten to disrupt the balance between costs and outcomes, creating real risk for customers as well as capital providers.

- Changing the sharing approach for totex out/underperformance based on companies' cost proposals was unexpected, given how well-signalled this had been as part of the methodology. In addition, it does not appear that second and third order consequences have been considered (such as for the RORE range of outcomes).

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We were pleased that Ofwat recognised the significant amount of customer engagement and support for the Company's business plan, of which everyone involved was justifiably proud. From our perspective as shareholders, the depth of engagement and level of assurance involved was unprecedented across the numerous regulated businesses that we have invested in over our long track record. We also welcome features adopted in the DD which had broad stakeholder support including the Canal & River Trust notified item and the collar for annual rewards and penalties.

We are, however, strongly of the view that the DD proposal for Bristol Water creates excessive risk for the Company and its customers while also failing to offer a viable basis for funding of the Company by its capital providers. Expectations and risk across the three key areas discussed above have been "dialled-up" in a seemingly piecemeal way at this late stage in the PR19 process, and the overall consequences of those interventions have resulted in Ofwat questioning Bristol Water's financial resilience.

Fortunately, the time exists to refine and join up the huge body of work undertaken to date with a view to ensuring an holistic and contextual plan for a resilient Bristol Water that is true to its customers' informed needs and wishes. In this vein, the Company has sought to amend its business plan in response to the DD challenge from Ofwat and its customers wherever appropriate. We do not underestimate, however, what needs to be achieved from this point given the breadth and seriousness of our concerns. As shareholder, we remain committed, alongside the Company, to do whatever we can to ensure that a workable Final Determination for Bristol Water and its customers is delivered in December.

We are available to discuss our views in more detail at your earliest convenience.

Yours sincerely

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Paul Malan
Senior Partner, iCON Infrastructure LLP