

Bristol Water Inquiry Group
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

Direct Line: _____
DX No: _____
Your Ref: _____
Our Ref: IV/SC

27 July 2015

Dear Sir,

**CMA PRICE DETERMINATION FOR BRISTOL WATER PLC
COMMENTS ON PROVISIONAL FINDINGS FROM SOUTH WEST WATER LIMITED**

Please find enclosed South West Water's comments on provisional findings in relation to the price determination for Bristol Water Plc.

Please do not hesitate to contact me if you have any questions.

Yours faithfully,

Iain Vosper
Regulatory Director

Encs.

CMA PRICE DETERMINATION FOR BRISTOL WATER PLC

COMMENTS ON PROVISIONAL FINDINGS FROM SOUTH WEST WATER LIMITED

We noted the provisional findings of the CMA for the Bristol Water price determination. It was clear to us that the inquiry panel had carefully considered the impact on customers of both the quality of service and bill levels. We would note that even with the small 2% increase in bills indicated in the provisional findings compared to the Ofwat original determination, the 17% reduction by 2020 before inflation for Bristol remains substantially larger than in other areas (i.e. 11% for Bournemouth Water is the next highest and 13% for South West Water once the 2014/15 early price freeze is taken into account).

Whilst we cannot comment on the full details of the provisional findings we would like to contribute the following observations:

Wholesale cost modelling

We would note that Ofwat's use of totex modelling was a specific suggestion from the review of Ofwat by David Gray after PR09. This review found indications of a bias in company planning and industry incentives towards capex. Therefore it is not surprising that Ofwat should in the first instance identify workable totex models, cross referring and triangulating these to separate "Botex" base and enhancement expenditure models and enhancement modelling where appropriate.

Ofwat had considered other approaches (for instance bottom up cost modelling of a stylised network that could then be applied to company circumstances), which may in the future prove to be more workable for sub-elements of the wholesale value chain.

We are therefore not surprised by the findings of the inquiry, that for this Bristol referral, simpler "botex" models and capital enhancement assessments were better for determining the issues associated with this case. There may be limited read across however to the wider challenge that Ofwat face in assessing the efficiency of company plans where there is a wider variety of opex and capex investment needs (often driven by past investment decisions and local geographic and environmental factors), with the need for the industry to focus on outcomes rather than output variables. Standardised outputs are becoming less useful in an industry where maturity means that direct cost comparisons become harder, particularly where best practice suggests companies look to changing external impacts such as land use to improve water quality at source, rather than in end of pipe physical solutions.

Cost of capital

We are pleased to note that the cost of capital is broadly unchanged to that identified at PR14, with no material difference overall to the judgement that Ofwat reached and that companies generally accepted when updating their business plans. Although the panel do

not specifically support Ofwat's approach to considering the customer benefits as part of the decision on whether to include a Small Company Premium to the cost of capital, we would note that the inquiry panel consideration of Bristol embedded debt offsets its inclusion. Whilst we think that there remain merits in Ofwat's approach, we agree with the panel that Ofwat should consider cost of capital against the financing duty and use other regulatory tools and mechanisms to consider the specific customer issues.

ODI incentives

We support the logic of the inquiry panel in the provision decision in being concerned that penalties for upper quartile levels of service risks customers paying for a service level that does not reflect their views. ODIs were designed to reflect a company specific economic level of service. The proposed approach to limit outcome incentive rewards to above an industry upper quartile level is more likely to protect customer long term interests than penalties that drive industry performance up to a fixed upper quartile level. We agree that there are issues of comparability with outcome incentives and the innovation benefits of the outcomes approach should make such comparisons less appropriate in the future.

Cost of capital

We note a reference to the 28% RCV premium that Pennon paid for Bournemouth Water within the consideration of the Market to Asset Ratios within the provisional decision. It should be noted that this includes Bournemouth Water's non-regulated plumbing and water services businesses. Excluding these components the RCV premium for Bournemouth Water was 24%. The transaction was funded by equity placement of Pennon shares.