



Luis Garcia
Bristol Water
By e-mail

10 October 2015

Dear Luis

Further Engagement with Bristol Water on wholesale water costs

Since we received your representation on Bristol Water's draft determination on 3 October 2014 we have spoken and met to discuss your proposed wholesale water expenditure (totex) over the next five years.

We agree that the issue of wholesale costs is very important for Bristol Water and your customers.

In the draft determination, there was a very large difference between your business plan and the level of wholesale costs which we considered to be efficient. We based this on a combination of our cost modelling and the evidence that you provided on cost exclusions. Our view of the wholesale water totex was £359m. This was £203m lower than put forward in your revised business plan, resulting in a totex 'gap' of 57%.

Even taking into account the proposed reduction in your plan between June and October of £21 million, Bristol Water is by far the most significant outlier within the sector with regards to wholesale costs.

Within your representations you made a formal request for Bristol Water and Ofwat to enter into mediation facilitated by a confidential body such as the Centre for Effective Dispute Resolution. You asked for a response by 17 October. This letter provides our formal response. While we understand that the proposal was well-intentioned, as we explained in our meeting on 6 October we do not consider mediation is

appropriate. There are a number of reasons for this:

- i. The use of mediation would not be consistent with the legal framework under which this industry operates. It would be a departure from the long-established regulatory system that has operated for over 25 years.
- ii. Ofwat, as an expert independent economic regulator for the industry, has the duty to conduct the price review and a mediator would have no obligation to be consistent with our statutory duties within which we operate.
- iii. The legislation provides for an established appeals body for the price determinations in the Competition and Markets Authority. Moreover, our published timeline establishes that final determinations will be published for all companies on 12 December 2014 and it is unlikely that a mediation process would be able to meet that deadline.
- iv. Bristol Water has been afforded a considerable number of opportunities to put forward a business plan that operates in its customers' interests. We first tested your plan following submission in December 2013 and informed you in March 2014 of the significant challenges we felt you needed to address regarding your planned levels of wholesale expenditure. We reached this assessment by using a number of different models and making comparisons across the water sector. Following the re-testing of your plan over the summer we gave you, along with two other companies, advance notice that we still felt you had not sufficiently addressed our challenges on wholesale costs and that a very material difference remained.

We do acknowledge the steps that you have taken since 6 August to address our challenges. In particular the further efficiency challenges you are adopting lead to a £21m reduction in your overall level of planned wholesale costs. However, we are concerned that Bristol Water remains in a very different position to all other companies at this stage in the process.

We are still progressing with our assessment of your representations. It will ultimately be a matter for the Ofwat Board to arrive at a final determination. However, given our concerns at this stage, we are willing to consider further engagement with Bristol Water on wholesale costs within the price control process on the basis of 4 key questions:

1. Why any adjustments to the wholesale water models are appropriate for Bristol Water in the context that our models satisfactorily explain costs across all 18 companies for whom we regulate prices for water services.
2. Whether there are elements of capital maintenance expenditure within your totex which are over and above what would be expected to be explained through our modelling.
3. The merit of the cost exclusion claims that you put forward in other areas, notably for enhancement expenditure such as the Cheddar 2 reservoir.
4. The assessment and assurance undertaken by your Board to reach its views of risk levels as part of your consideration of wholesale costs.

Consistent with our commitment to transparency we are publishing this letter to highlight that we are providing Bristol Water with this final opportunity for additional engagement beyond our published process only because of the scale of the wholesale cost gap.

To ensure transparency we may publish any additional material provided by Bristol Water which was not provided as a direct response to a query raised by us. This may include notes of meetings or telephone conversations, where appropriate. It is important to note that it will be at our discretion as to whether we consider any new information or evidence that you present to us, as this will be received after the 3 October deadline which applied to all companies.

In areas other than wholesale costs where you have made representations, there is not the same material difference between Bristol Water and other companies. Therefore any additional engagement or information you provide will be restricted to Bristol Water's wholesale costs.

To confirm again, this letter does not pre-empt your final determination and we have yet to fully assess the representations you submitted to us on 3 October.

Yours sincerely



Sonia Brown
Chief Regulation Officer