Anglian Water: Response to Ofwat further submissions

Reference of the PR19 final determinations: Response to Anglian Water's 27 May submission to the CMA		
Para number	Relevant Ofwat text	ANH 6 July response
Growth		
2.14	*By accepting Anglian Water's business plan, we would implicitly be accepting its forecast unit costs in relation to growth expenditure and would ignore the outcome of our comparative analysis.*	It is for the CMA to determine the weight placed on Ofwat's approach to deriving growth expenditure allowances. Anglian notes that during the CMA redetermination process, Ofwat has published a consultation[1] which contains materials that the CMA may consider relevant. This consultation provides some benchmarking of company charges for connection services. Anglian appears to have relatively low charges (implying comparative efficiency) while also experiencing high-levels of competitor activity (see pages 20-23). Ofwat's analysis corroborates Anglian's own benchmarking of site specific costs provided in SOC186.
2.19	*The cost allocation issues between growth and base costs also mean it is not possible to derive the 'true' growth implied allowance from the base cost models. We therefore do not consider it is appropriate to place substantial weight on any growth implicit allowance analysis.*	We believe it is important to be able to assess growth expenditure as part of a price review process. As part of the redetermination process, we expect the CMA will seek to come to a conclusion on the appropriate level of allowance for growth expenditure. Ofwat itself previously provided to Anglian an implicit growth allowance (SOC355). The difference between Anglian's view of growth costs and Ofwat's view is significant, and also gives rise to the opex-capex misallocation explained in Anglian's SOC (chapter E.5) and Anglian's Reply to Ofwat's response (REP08, part G7).

[1] Ofwat (May 2020) Charging arrangements for new connection services for English companies: comparative analysis and consultation', available here: https://www.ofwat.gov.uk/consultation/charging-arrangements-for-new-connection-services-for-english-companies-comparative-analysis-and-consultation/

		The opex-capex misallocation issue is separate to the difference in view of appropriate growth costs – i.e. even if Anglian were to accept Ofwat's view of appropriate growth forecasts and costs, it would still have a significant shortfall in opex, because of this misallocation of costs between capex and opex.
2.23	*The new evidence presented by Anglian Water's advisors, Vivid Economics, ~~is not convincing. It~~ does not test its remoteness and growth intensity explanatory variables in our base cost models to assess whether these factors are already captured by the other explanatory variables.*	With respect to remoteness of growth and remoteness of base population Vivid demonstrate in their May note (REP12), "The two are not the same and are only weakly correlated (as figures provided in the appendix demonstrate), meaning they cannot function as proxy variables." (REP12, Page 3, paragraph 8). As they are not well correlated, Ofwat cannot be capturing this explanatory variable through its approach as suggested. Using forecast population growth does not capture whether this growth is in high or low density areas or in areas with more or less existing capacity to deal with the growth. These factors need to be jointly considered to assess the impacts on growth costs. (REP12, Page 3, paragraphs 8-9)
2.24	*We also note that Vivid Economics' remoteness and growth intensity explanatory variables perform poorly in a number of its own standalone growth forecast cost models.* *We have also been unable to verify the underlying input data behind these variables. To use these variables in cost assessment it would therefore be necessary to ensure that: (i) the data behind these variables is of sufficient quality; and (ii) the model results are not sensitive to the underlying assumptions made.*	The Vivid report (SOC369) sets out in detail the full range of models assessed to derive how econometric evidence can be used to inform the assessment of growth costs. Ofwat's comments reflect that, as expected with exercises of this nature, when following a systematic approach there will be some models that are not sufficiently robust that are appropriately discarded. Turning to the detail of the variables themselves, Vivid's report (SOC369) sets out in detail the economic rationale behind these variables, when they would be expected to be important drivers, and when not. the definitions of these variables are provided in Table 4 of SOC369. The statistical annex to SOC369 briefly sets out how each driver is computed and provides evidence of its robustness. As set out on page 20 of the Vivid report (March

		2020 SOC369) the code used for the generation of these drivers is available on request should the CMA require it. SOC369 set out the basis for how the variables used were developed and the underlying data sources. These used either published industry company level data or wider information from publicly available data (for example Land Registry information – which shows the postcode of new houses and flats for sale). This gives granular information on the location of building and new connections for the whole country in a consistent way. The overall conclusion of this work demonstrated that for both water and wastewater services, there is strong statistical support for reflecting the importance of special profiles of growth (i.e. remoteness and growth intensity) in determining efficient growth costs (SOC369, Executive Summary pages 2-3).
Capital maintenance		
2.32	*Anglian Water highlights that cycles of capital maintenance investment follow the price control cycle. We take this as evidence that companies do manage risks arising from the underlying asset base within their allowance, balancing meeting budgetary and performance targets and the quality of any case to invest.*	The evidence Anglian provided (REP 08, part G.2, page 21 figures 2 and 3) cannot be used to draw the conclusion Ofwat sets out. These industry charts simply represent annual variation in expenditure linked to price control periods in the context of demonstrating an increasing long term trend. No conclusion of spending within specific allowances can be drawn from this information.
2.34	*We acknowledge that capital maintenance in any given year may not directly correspond to the underlying cost drivers in that year, and smoothing is a potential approach to mitigate this. However, there are also disadvantages to smoothing capital maintenance, as noted in Bristol Water's PR14 final determination by the CMA. This led to the CMA adopting econometric models with unsmoothed cost data after weighing up the pros and cons of using smoothed data.*	This misrepresents the CMA's approach to Bristol Water's PR14 redetermination. The CMA used four models with smoothed data and three models with unsmoothed data in its Bristol PR14 re-determination. The CMA took the average across a smoothed and an unsmoothed approach (adjusted to give results more in line with the smoothed approach).

Anglian Water: Response to Ofwat further submissions

Supply demand balance		
2.54 – 2.55	*The Environment Agency's National Framework and draft WRMP24 guidance both include the need to provide resilience for a 1-in-500 year drought event, no later than 2039. However, the WRMP24 guidance is still in draft form and will not be finalised and published until January 2021.The draft guidance is clear that flexibility is required and costs and benefits should be considered.* *The 1-in-500 drought scenario is only one of a number of scenarios that Anglian Water includes in the stress testing and least worst regrets analysis it considers justifies its best value plan. If the 1-in-500 scenario was the key driver of the company's WRMP, we would have expected the company to clearly present this in its planning tables and highlight this in its consultations.*	Anglian confirms that the 1-in-500 year drought event was not a key driver of WRMP19 (which was concerned with achieving 1 in 200 year). The 1-in-500 year drought event formed part of several stress test scenarios of the Anglian WRMP. Other test scenarios included testing for growth, high climate change, additional exports, and new resource schemes. SOC220 – WRMP least worst regrets analysis sets out these scenarios in further detail. Resilience to the 1-in-500 scenario informed the development (but was not the key driver) of our Best Value Plan (BVP). It is the BVP upon which the scope of the interconnectors is based.
Reference of the PR19 final determinations: Cross cutting issues – response to companies' 27 May submissions to the CMA		
Para number	Relevant Ofwat text	ANH 6 July response
RPE and productivity		
2.14	*In our final determination we applied a frontier shift efficiency challenge (and real price effects (RPE) allowance) to elements of enhancement costs which are more common across companies including the wastewater elements of the Water Industry National Environment Programme (WINEP) and metering costs. This is because companies had not applied a net frontier shift challenge (frontier shift less real price effects allowance) to these costs.*	This is not correct. Anglian and other companies applied frontier shift, consisting of the combination of productivity improvements and RPE movement to these costs. Details of the approach were set out in our previous business plan submission (SOC001, pages 102-106), Chapter E4 of SOC (para 828) and REP08 (Part G6: reply on frontier shift)
2.15	*Disputing companies raise some new arguments on our application of net frontier shift to WINEP costs including:* *- Applying frontier shift to enhancement costs such as WINEP is double counting the efficiency gain as companies already included a frontier shift efficiency challenge in their enhancement costs.*	This is incorrect. Our point about double-counting as a result of applying frontier shift to enhancement costs is not a new argument - see our SOC (Chapter E.4, section 4.3).

	- Companies were asked to submit future efficient costs which by definition would include future efficiency improvements including frontier shift impacts. *- Ofwat should have clarified that costs should be provided excluding frontier shift and real price effects.* *- Dŵr Cymru (WINEP benchmark upper quartile company) included a 1% p.a. efficiency challenge to all its schemes including WINEP.*	
2.16	*Anglian Water and Yorkshire Water both now clearly state their view that frontier shift should not be applied to metering costs due to double-counting of efficiency improvements.*	This is incorrect. Our point about the double-count on metering is not new. Anglian previously set out that it *"disagrees with the application of frontier shift adjustments to cost allowances which already include such adjustments. Anglian therefore disagrees with the extended application which Ofwat made at FD. Ofwat's allowances for unmodelled base costs and enhancement costs were based on companies' future forecasts which already include frontier shift adjustments"*. The enhancement costs referred to in this paragraph of Anglian's SOC include metering costs and WINEP costs and Anglian made no distinction between the two (SOC, Chapter E4: Frontier Shift, section 4.3 para 850)
2.17	*Companies state that where they have applied a frontier shift challenge which is the same magnitude as a real price effects allowance, they should be exempt from any further frontier shift challenge. This is fundamentally misconceived.* *In applying our frontier shift to company costs, the frontier shift is netted of any real price effects allowance to determine the net frontier shift challenge imposed on company costs. It is therefore important to identify whether the companies have applied a frontier shift adjustment net of any real price adjustment that is relevant.*	We disagree that this is the correct approach. The first sentence challenges the companies' position but the last sentence endorses it. We note that Ofwat has adopted a new term - net frontier shift - to recognise the link between productivity and RPE. We have consistently used the term frontier shift for this purpose and set this out fully in our Reply (REP08 Part G.6, paras 217-219). The central challenge to Ofwat's approach remains that if companies themselves have applied a frontier shift reflecting both elements of productivity improvements and RPE movements then Ofwat's approach results in applying frontier shift twice to enhancement costs.
2.20	*We reviewed company business plan assumptions regarding application of a net frontier shift challenge to enhancement costs. Table 2.1 below summarises the most recent frontier shift and real price effects*	The table shows that ANH, NES and BRL made net frontier shift adjustments to their costs; their projections of productivity and RPE simply mean that the net figure was 0 or positive. The reference to YKY confirms that Ofwat

	assumptions outlined by the disputing companies in their PR19 business plans. This table shows that none of the disputing companies imposed a net frontier shift challenge on their enhancement costs, with Anglian Water applying a net increase. We acknowledge the specific way in which companies have applied these assumptions to their costs can be somewhat unclear due to variances in App24a reporting and data table commentaries as outline above. In particular, Yorkshire Water reports efficiency gains in App24a but does not specify whether any of those reflect a frontier shift assumption	does not know what companies assumed before its application of frontier shift challenge to enhancement costs. In any case, Ofwat's figures for ANH are incorrect. We applied a net frontier shift challenge of £28m to our enhancement programme (including WINEP and metering) - see the waterfall diagram included in our SOC (section E.3, para 755).
General	Europe Economics – Response to some key points on RPEs and Frontier Shift	We append to this response a short note prepared by John Earwaker which provides comment on the detail of this report.
PR14 expenditure		
2.26	*While we acknowledge that there could be changes in the NEP during the price control period, these changes need to be agreed with the Environment Agency. This typically involved one named scheme being swapped with another named scheme of a similar size. Due to the six yearly nature of the environmental regulatory cycle, the NEP was one year further on in its development at the time of the final determinations for PR14 compared to the WINEP for PR19 and so the NEP was more certain.*	The NEP was not more certain, this is an oversimplification. There were considerable changes[2] to the scope of the NEP programme after the PR14 FD which also helped achieve additional scale efficiency savings in AMP6 (which are reflected in our AMP7 plan) but this could not have been foreseen at PR14. The costs for delivered schemes inform the proposed PR19 costs for similar investments after taking into account further efficiency drivers such as AMP7 frontier shift reflected in Anglian's plan. This process is set out in Chapter B3 of our SOC. For PR19, the EA developed an approach has been developed to manage uncertainty in the WINEP programme using a traffic light system. This WINEP Managing Uncertainty mechanism corrects for this. For PR19, all schemes reported as Green (certain) or Amber (uncertain) have been reflected in companies' plans with associated investment. There is a customer protection mechanism in place should the Amber schemes such that the costs associated with amber schemes will be returned to customers if they no longer needed to be delivered in AMP7.

[2] For example, of the 28 P-Removal schemes in Anglian's PR14 Business Plan only 10 of the total 48 schemes delivered related to schemes originally in the PR14 Business Plan. File 02a – RFI006 – Question 14 Response sets out full details.

		Our response to the recent RFI006 (response to questions 14d and 14e) sets this out in further detail.
Reference of the PR19 final determinations: Risk and return – response to common issues in companies' 27 May submissions to the CMA		
Para number	Relevant Ofwat text	ANH 6 July response
Embedded debt		
3.39	*We observe that our approach to remunerating the cost of debt means that a total of 20 years of iBoxx yields will be encompassed by our overall allowance by the end of the 2020-25 regulatory period, and that in 2025, iBoxx yields from 2005 will still be reflected in our overall allowance. It is therefore more accurate to describe our allowance as remunerating historic debt of up to 20 years tenor at issuance. We consider the 20 years spanned by our final determination approach to be fairly matched with the roughly 20 year average asset life in the sector as implied by RCV run-off rates, and also the weighted average years to-* *maturity of the iBoxx A/BBB (21 years)*	Ofwat's submission has set out new evidence in various areas, including its description of a 15-year trailing average period for setting the cost of embedded debt allowance. Ofwat's argument is that in practice its policy in relation to cost of debt allowance is consistent with the economic life of assets in the sector (20 years) and the weighted average years to maturity of the iBoxx (21 years). This misrepresents the policy applied by Ofwat in calculating the cost of debt allowance. Ofwat has used a 15-year trailing average which only takes into account market conditions up to 15 years before the start of AMP7 (i.e. 2005 to 2020). This means that if a company raised 20 Year debt in 2003 in line with the iBoxx index, it would not be captured in the Ofwat trailing average. In fact, around 20% of the outstanding debt across the sector sits in that category, meaning that, even if it was efficiently raised at the time, it would be left out by Ofwat's approach in the FD.
Beta		
General	Europe Economics, Further comments regarding beta, June 2020	Anglian appends to this response a short note prepared by Alan Gregory, Richard Harris and Rajesh Tharyan responding to the EE report.