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Dear Kip

### **Follow up to Peter’s letter after our Hearing**

Before the deadline of 17 August for further correspondence, we have reflected carefully on the advice you gave to avoid repeating arguments already made, and are acutely aware of the wealth of material already provided, and the scale of the task before you as you move towards Provisional Findings.

This response is therefore short, does not repeat areas of disagreement already set out or seek to correct factual points from the transcripts. Rather, it follows on from Peter’s letter to you after our hearing on 5 August.

### **One-off or Recurring costs**

Robin explored this general point with us in the Hearing, and Peter talked through how we had delivered the improvements to our performance on supply interruptions through increasing expenditure in this area by £17.9m during AMP6.

Reflecting further on this point, we considered it may be helpful to provide a breakdown of those costs so that the CMA can see which elements are one-off, and which recurring. This is attached as a Table in the Annex to this letter.

It shows that £12.9m (72%) of the £17.9m AMP6 expenditure on supply interruptions reported in the Statement of Case, is recurring expenditure. We have already also provided similar detail on our base leakage costs to the CMA staff team.

### **Remedies**

We have further reflected on the most material issues, where the CMA could make changes which would help to address our key concerns, without having to unwind the whole of the PR19 framework.

*Base Costs*

Appropriately reflecting Average Pumping Head, restoring our base leakage cost adjustment claim, suitably reflecting economies of scale at Water Recycling Centres and identifying an appropriate benchmark given the inaccuracy of the models would resolve the £265m shortfall and address the risks of insufficient funding being available for capital maintenance. This can be achieved without having to develop a full new set of econometric models.

#### *Growth Costs*

The growth issues can be addressed by setting cost allowances against a more realistic growth forecast, revising the cost assessment to fully capture the drivers of growth expenditure, and implementing our proposed true up mechanism for investment at WRCs to protect customers should growth vary from forecasts.

#### *Enhancement Costs*

Different approaches to five major areas would enable essential improvements in quality and resilience for customers and the environment. As we discussed at the hearing, we would also expect customer protection mechanisms to operate for enhancement schemes within the Redetermination. The five areas are:

- *Smart Meters*: Allowing the £42m smart metering cost adjustment claim to enable delivery of the full scope of the AMP7 smart meter rollout;
- *Interconnectors*: Reversal of the capacity constraints introduced by the FD and moving the Elsham transfer and storage schemes out of DPC;
- *WRMP*: Removing the company-specific efficiency challenge on supply-demand investment given the evidence provided of efficiency of these costs;
- *WINEP*: Removal of the "double count" frontier shift applied to WINEP and other non-modelled costs.
- *WINEP*: identifying an appropriate benchmark given the inaccuracy of the models

#### *ODIs*

The most material issues on ODIs which we believe need to be addressed are:

- *Leakage* – calibration of the performance commitment level to reflect the appropriate balance of risk associated with shifting the sector frontier;
- *Interconnectors* – recalibrating the ODI so that the focus is on delivering the best long-term resilient outcomes rather than constraining future option;
- *Interruptions to Supply* – updating the commitment level to reflect customers' preferences and an appropriate level of penalty exposure; and
- *Water Quality contacts* – updating the commitment level to reflect customers' preferences.

#### *Financing issues*

At a high-level, we propose:

- *Gearing outperformance sharing mechanism* – removal of the proposed mechanism;
- *Opex-Capex misallocation* – ensuring the cost recovery is aligned to the type of expenditure in the determination
- *WaCC and Financeability* – correcting the methodological issues, specifically regarding the inflator used to assess historic market returns, allowing the costs of efficiently-incurred embedded debt, and addressing the fact that the PAYG adjustment does not resolve the financeability issues the FD creates for the notional company.

#### *Cost-sharing Ratios*

Finally, as we have set out to you, we believe that it is important that the CMA adopts a cost-sharing ratio that does not penalise the company for having proposed an ambitious plan or sought to use the option available in the legislation to seek a reference to the CMA.

I am also very grateful for the consideration you are giving to the longer-term issues regarding regulation of the sector. The CMA's views on these matters will be critical in helping us all to address the acute challenges of growth and climate change we face in the years to come.

I hope this is helpful. Thank you again for all the work that the Panel and the CMA team have put into the Redetermination.

Yours sincerely

Alex Plant  
**Director of Strategy and Regulation**

## Annex: Breakdown of supply interruptions AMP6 expenditure

Expenditure area	AMP6 costs (£m)	One-off or recurring	Additional comment
i) identified 500 high risk mains and separately completed seven mains connectivity schemes to enable water to be brought from alternative sources (network interconnectivity)	0.2	One-off	Mains investment to increase resilience.
(ii) installed more than 100 devices to remotely reset pumps which have tripped (remote resets)	0.4	One-off	Whilst considered one-off, the assets will require some on-going routine maintenance
(iii) upgraded its network pressure monitor reporting system (asset monitoring)	1.0	One-off	Will require replacement in the future. Ongoing support and maintenance costs.
(iv) purchased additional pressure loggers so that each technician has two available to use during an event, to better understand the area affected and help the validation of results (asset monitoring)	0.4	Recurring	New pressure loggers –these shorter-lived assets will require routine maintenance and replacement.
(v) employed 35 additional employees to form a new restoration team to help maintain supplies via temporary overland mains and tankering of water into the supply network, to facilitate the approach of 'restore before repair'	12.1	Recurring	We now twin track our response to burst mains and deploy repair teams to resolve the issue, and a restoration team to restore supplies. This means more employees attend an event to resolve issues as quickly as possible. We do not have the capacity in this team to provide restoration to all events, hence the need for a larger team in AMP7. We also use them to maintain supplies to customers during planned works.
(vi) bought mobile pumps, installed pressure reducing valves and automated innovative valve and new generators, and installed additional generator sockets to support issues and provide resilience	2.9	One-off	Will require on-going maintenance and replacement at a future date
(vii) made pipework modifications at five water treatment works where it assessed a high risk of supply failure, to enable emergency treatment if required	0.5	One-off	
(viii) developed its critical spares stocks to support rapid repair and restoration	0.4	Recurring	
<b>Total AMP6</b>	<b>17.9</b>		