

Anglian Water

PR19 CMA Redetermination

Reply to Responses to CMA Provisional Findings

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Table of Contents

Contents	Page
Chapter A: Executive Summary	3
Chapter B: Ofwat's "Fundamental Errors" Document	4
Chapter C: Security of Supply concerns: DPC	5
1 Direct Procurement for Customers	5
2 Ofwat's response mischaracterises the CMA PFs position	5
3 Request to the CMA	7
Chapter D: Totex	8
1 Overview	8
2 Third party views	8
3 Leakage	8
4 Dealing with STW growth expenditure	11
5 Botex: Use of 2019/20 industry data	12
6 Metaldehyde	15
7 Bioresources	15
Chapter E: Financing	17
1 Overview	17
2 Ofwat's criticisms of the CMA's assessment of the cost of equity	18
3 Ofwat's criticisms of the CMA's approach to cost of embedded debt	20
4 Comments on Ofwat's response to PFs on opex/capex misallocation	22
5 Ofwat's criticisms of the CMA's approach to gearing sharing outperformance mechanism	23
6 Ofwat's use of share price information in criticising the CMA's approach to financeability	23

Chapter A: Executive Summary

- (1) Anglian has considered in detail the responses to the CMA's Provisional Findings ("**PF responses**") and is pleased to set out some targeted points by way of reply.
- (2) This reply focusses only on material issues relating to new evidence presented in the PF responses, either by main parties or third parties. It does not seek to respond to every point raised, even where Anglian disagrees with these. Where the CMA expects to carry out further work or has explicitly sought further views, such as for leakage, these are signposted. Where no new evidence is presented beyond that already considered by the CMA, Anglian offers no further comment. This is consistent with Anglian's previous responses and reflects its view that the PFs only require targeted changes.
- (3) This approach is also consistent with the CMA's requests for main parties to focus on the provision of new evidence and arguments in their subsequent submissions to the CMA.¹
- (4) In reaching its PFs, the CMA has considered the evidence and analysis put before it. While Anglian disagrees with some of the CMA's conclusions, it does not wish to prolong the process unnecessarily, absent of material new evidence to present. Contrary to Ofwat's PF response,² which inappropriately dismisses companies' legitimate concerns, Anglian considers there would be material customer detriment associated with a two-month delay to the proposed mid-December timetable for publication of the Redetermination.
- (5) Anglian has proposed a solution that, with limited compromises from companies, Ofwat and the CMA, allows time for sufficient further consideration of the remaining open issues where new evidence has been presented, avoids detriment to customers from longer delay, and ensures timely investment to secure resilient water resources during AMP7 and beyond.³
- (6) Ofwat also asserts, but does not evidence, that the CMA has made a number of fundamental errors in its approach which are substantive and procedural.⁴ Anglian does not consider Ofwat's assertions to be credible.
- (7) Anglian regrets that Ofwat has chosen to make comments in the media in the way it has.⁵ This harms perceptions of the legitimacy of the UK's regulatory regimes. It is better for all parties to make points in a measured way through the proper regulatory process.
- (8) Finally, Anglian notes that the CMA, Ofwat, the appellate companies and third parties all make recommendations on aspects of the regulatory framework that need to change for PR24 and beyond. These build on Anglian's observations that regulatory reform is essential for the urgent challenges facing the sector to be met. This can only be achieved through better collaboration and more constructive engagement than has been seen for PR19.

¹ CMA letter to main parties - 5 November 2020, page 2.

² Ofwat, Reference of the PR19 final determinations: Fundamental errors of approach - response to CMA provisional findings, section 2, page 24.

³ Anglian's reply to Douglas Cooper's letter of 5 November 2020.

⁴ Ofwat, Reference of the PR19 final determinations: Fundamental errors of approach - response to CMA provisional findings, para. 11.

⁵ Ofwat PN16/20: Ofwat warns water customers could pay more and investors receive a windfall available [here](#); Rachel Fletcher appeared on Radio 4 Today Programme 28 October 2020; available to listen back to on BBC Sounds available [here](#) (begins at 2:42:25).

Chapter B: Ofwat's "Fundamental Errors" Document

- (9) Anglian is concerned by many statements in Ofwat's "Fundamental Errors of Approach" response document. Anglian does not recite specific passages here but refers in particular, to paragraphs 1.44, 1.51-1.53 (inclusive), 1.66 and 1.81.
- (10) Anglian does not seek to advise the CMA on the "correct" approach to conducting its Redetermination, but notes the CMA has wide discretion in weighing up the various sources of evidence available to it. The CMA is required to disclose the gist of its reasoning, but not every piece of underlying evidence. Accordingly, it seems to Anglian that the arguments advanced by Ofwat (referred to above) do not deserve credence for the following reasons:
- (i) In publishing its PFs in line with the process identified at the outset, Anglian considers that the CMA has satisfied its duty, as a public body, to act fairly (including its duty to consult).
 - (ii) While procedural fairness requires disclosure to enable a proper opportunity to respond, challenge and correct, the CMA is not obliged to disclose each and every piece of specified information but rather the "gist" of the case. Indeed, Ofwat accepts that *"the provisional findings cannot be expected to document or address every line of argument or each piece of evidence submitted by the parties..."*⁶ Given that, in addition to the PFs, Ofwat has seen all responses to Requests for Information and the vast majority of the evidence submitted throughout the process, Anglian does not understand the basis for Ofwat's allegations of "insufficient disclosure" (for example in relation to Anglian's strategic interconnector scheme).⁷
 - (iii) Equally, whilst the CMA has a statutory obligation to arrive at a reasoned final decision,⁸ it retains discretion around the level of reasoning that is expedient to disclose for facilitating a proper understanding of its conclusions.
 - (iv) Anglian acknowledges that Ofwat has a statutory duty to assist the CMA with its redetermination and that the CMA must "take account" of information provided by Ofwat in this context.⁹ However, it appears that Ofwat is stretching the scope of this statutory requirement by seeking to establish a higher burden for the CMA when it comes to considering and assessing Ofwat's submissions and evidence.
 - (v) The CMA is not required to apply greater weight to Ofwat's submissions than to other sources of evidence, or to explain in greater detail its assessment of that evidence. Even if it could be argued (which Anglian does not accept) that the CMA has given "insufficient" weight to Ofwat's evidence, this would not lead to the conclusion that the CMA's PFs are "insupportable".
- (11) Finally, Anglian disagrees with Ofwat's view that there is no justification for specific alleged differences between the PFs and the CMA's previous determinations. As this is a redetermination, the CMA has exercised its discretion as to how it balances its statutory duties (including the new resilience duty and the duty in relation to the Government's SPS). The CMA has acknowledged that in balancing its duties, it must have regard to regulatory precedent to the extent relevant but has noted that previous approaches can be departed from where justified.¹⁰ Anglian agrees with this approach given the statutory objectives relevant to this Redetermination.

⁶ Ofwat, Reference of the PR19 final determinations: Fundamental errors of approach – response to CMA provisional findings, para. 1.49.

⁷ See e.g. Ofwat, Reference of the PR19 final determinations: Fundamental errors of approach – response to CMA provisional findings, para. 1.60.

⁸ Section 12(3C), WIA91.

⁹ Sections 14(5) and 12(3B), WIA91.

¹⁰ PFs, para. 2.68.

Chapter C: Security of Supply concerns: DPC

1 Direct Procurement for Customers

- (12) In Anglian's PFs response (the "**AWPF Response**") it noted that, despite significant efforts, discussions with Ofwat had not resulted in agreement on the scope of the DPC project. Anglian considers that unless the scope of the DPC is reduced it will be unable to:
- (i) meet its legal environmental obligations during AMP7;
 - (ii) ensure security of water supply to customers; and
 - (iii) meet the level of drought resilience agreed in WRMP19.
- (13) Anglian has therefore asked the CMA to revise the DPC scope, so that only the Elsham treatment element (CLN13a) is taken through the DPC process.¹¹ Ofwat's position¹² in relation to the scope of the DPC scheme (set out in its response to the PFs) is that:
- (i) the de-scoping of the Elsham scheme potentially results in significantly higher costs for customers;
 - (ii) Ofwat has not been presented with clear arguments as to why the whole Elsham scheme can't be delivered within required timeframes through a DPC process; and
 - (iii) Ofwat has supporting legal advice which suggests that many issues on timing raised by Anglian could be resolvable through a slightly different structure to the process.
- (14) Anglian addresses these points below. It also briefly sets out evidence that a focus on taking the Elsham treatment works only through the DPC process during AMP7 both delivers potential value for money ("**VfM**") to customers and shows Anglian's commitment to the DPC process, which will help to learn lessons for future strategic water resource schemes in AMP8 and beyond where an effective DPC process could yield further customer benefit.
- (15) Anglian has repeatedly stated its underlying commitment to developing markets where in the interests of customers. In recent correspondence,¹³ Anglian explained the mutual dependency between Anglian and Ofwat to ensure DPC works well, recognising how important it is for Anglian, new market participants, and Ofwat to learn the lessons from this. This learning will enable larger projects, such as a potential new reservoir in AMP8, to be taken forward with the benefit of that experience, and generate even greater benefits for customers. Anglian hopes these issues can be discussed in its proposed hearing.

2 Ofwat's response mischaracterises the CMA PFs position

- (16) First and foremost, Ofwat mischaracterises the PFs position on Elsham and DPC.¹⁴ The CMA's decision not to reflect in its PFs was based on the view Anglian expressed at its hearing that it was actively discussing the scope of DPC with Ofwat and expected the matter to be resolved. At the time of publication of the PFs this remained the case.
- (17) Therefore, the CMA's PF position (where it did not opine on the matter) was linked to Anglian's explanations that dialogue was continuing. It was not, as Ofwat suggests, based on Ofwat's commitment

¹¹ AWPF Response, Chapter E: Enhancement, section 3.5, pages 33-37.

¹² Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, pages 55-56.

¹³ DPC Letter and note October 2020 (PF010).

¹⁴ *Ibid* specifically first bullet under "CMA provisional finding" and "Ofwat response" on page 55 relating to Elsham Direct Procurement for Customers scheme.

to consult on licence changes to deal with uncertainties and the potential route for managing changes to delivery routes, including scope. Ofwat has not adequately represented the extensive dialogue between itself and Anglian, undertaken in good faith to seek to resolve these issues.

- (18) Had the dialogue between Anglian and Ofwat led to agreement on a revised DPC scope, this could have been put to the CMA, so that the Redetermination could reflect this and enable the urgent work to commence to help Anglian meet its environmental obligations and ensure security of water supply for customers. Anglian has expressed these views in correspondence with Ofwat, submitted as part of its PFs response¹⁵ and now asks that the CMA assess the correct scope for Elsham DPC in its Redetermination. Ofwat's response fails to account for the wider risks and benefits to customers
- (19) Ofwat makes no reference to the potential harm to customers and the environment if the environmental obligations to which Anglian is subject cannot be met. Customers face risks of insufficient supply, and the environment faces risks of over-abstraction. Any consideration of potential financial benefits for customers under DPC should be set against these risks.
- (20) Ofwat is referring to potential financial benefit for customers should the DPC process deliver a lower overall cost than if Anglian delivered the schemes in-house. Yet:
- (i) Any relative benefit is highly uncertain. It relies on an assumption that: (a) the DPC process works and a Commercially Appointed Provider ("**CAP**") is appointable, and (b) that the CAP would deliver a much lower overall cost than an in-house alternative. Neither of these are guaranteed, particularly with first of a kind schemes of such complexity and which are not discrete from the wider network that Anglian must operate. The weight placed on the potential gains should be adjusted accordingly;
 - (ii) If Anglian delivered these schemes in-house, it would return £4.4m of totex provided in the FD to run these elements of the DPC process.¹⁶ This is a guaranteed reduction for customers, which should be offset against a potential gain from DPC;
 - (iii) Customers receive greater protection through increased incentive rates for the Interconnector delivery ODI for all interconnectors to be delivered by Anglian; and
 - (iv) The potential reward for Anglian set out in the DPC performance commitment is also reduced by over £0.4m.¹⁷

2.1 DPC Timetable

- (21) As Anglian explained in the AWPf Response,¹⁸ the current scope of the DPC scheme consists of three elements being:
- (i) Elsham to Lincoln transfer (Ref: CLN16);
 - (ii) Elsham Transfer and storage from East Lincolnshire (Ref: CLN15); and
 - (iii) New Elsham Water Treatment works (Elsham treatment) (Ref: CLN13a).
- (22) Anglian has previously shown to Ofwat and latterly the CMA¹⁹ that the timetable constraints related to the first two components above will prevent them being delivered within the timeframe required by the Environment Agency ("**EA**") and will not allow the additional water to be available by 2025. The advice

¹⁵ DPC Letter and note October 2020 (PF010).

¹⁶ AWPf Response, Table 10 Revised DPC development allowance for Elsham Treatment works only going through DPC, page 36.

¹⁷ AWPf Response, para. 209.

¹⁸ AWPf Response, para. 185.

¹⁹ DPC Letter and note October 2020 (PF010); DPC presentation to support meeting held on 28 September 2020 (PF010A).

referenced by Ofwat in its PF response, shared with Anglian, does not address these timetable concerns.

2.2 Rescoping the Elsham to focus purely on the treatment element (CLN13a) will enable all parties to learn from the DPC process whilst ensuring that Anglian is able to meet its AMP7 environmental obligations

- (23) Anglian has also done further work to establish that the treatment works component still represents value for money for customers as a stand-alone DPC project, and has committed to do all it can to ensure the DPC process is successful, recognising the value of learning lessons from this early scheme to deploy for expected larger DPC schemes in future.

2.3 Strategic Interconnectors Performance Commitment ("PC")

- (24) Ofwat's PF response agrees that definitions and requirements for the Strategic Interconnectors performance commitment should be defined against capacity delivered.²⁰
- (25) Ofwat suggests that, should the PC be amended to be an "end of period" as opposed to an "in-period" ODI, this should be accompanied with a reputational incentive to report publicly on (annual) progress on the Strategic Interconnectors Programme within the performance commitment.²¹ Anglian does not consider it necessary to prescribe this requirement directly within the PC commitment given the wider requirements specifically relating to annual performance reporting, including annual updates on delivery of our WRMP. Given the significance of this investment to deliver the security of supply in the region by the end of AMP7 this will be captured by wider reporting in addition to the end of period ODI.

3 Request to the CMA

- (26) Anglian therefore asks that the CMA in its Redetermination revise this scope, so that only the Elsham treatment element (CLN13a) is taken through the DPC process. The transfer and storage elements of the scheme would be delivered by Anglian along with the remainder of the AMP7 Strategic interconnectors programme. This change, combined with Anglian's smart metering programme and further leakage reduction, will ensure the supply-demand balance in every Water Resource Zone in the region can be maintained through AMP7.
- (27) Anglian is now asking the CMA to make this change as part of its Redetermination as this would resolve matters swiftly and mitigate the risk of its environmental obligations not being met. Clearly, any delay to the receipt of its Redetermination would increase this risk.
- (28) Anglian has considered whether these changes could instead be addressed through a DPC IDoK mechanism, but this process is uncertain and can take many months to resolve, all of which prevents the necessary early start on the schemes and fails to use the CMA redetermination process to expediently mitigate this risk. ✂. ✂. All of this means that the region's water supply challenges are acute and urgent and securing an early resolution of a reduced scope of DPC is one essential means to address them.

²⁰ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 44 third bullet.

²¹ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 44-45.

Chapter D: Totex

1 Overview

- (29) In this chapter, Anglian sets out brief responses to a number of targeted issues:
- (i) Responses to third party responses to the PFs relating to totex investment;
 - (ii) Base and enhancement leakage proposals;
 - (iii) Ofwat's counterproposal to the CMA for dealing with growth at water recycling centres and its new analysis of over-funding risk through the growth true-up;
 - (iv) The use of 2019-20 data in totex modelling and Ofwat's objections to its use;
 - (v) Ofwat's suggested expenditure requirement for metaldehyde; and
 - (vi) Ofwat's comments on Bioresources investment.

2 Third party views

- (30) Anglian notes that most third parties support the conclusions of the PFs where they result in increased cost allowances. Anglian's Customer Engagement Forum noted that:

"The CEF welcomes the CMA's Provisional Findings (PF) in providing greater certainty that the service and other enhancements articulated by customers during the engagement carried out with them by Anglian Water can be delivered".²²

- (31) Blueprint for Water ("**BfW**") highlights that "Ofwat's strategy is ambitious on long-term challenges and environmental delivery, yet funding decisions sometimes seem at odds with these aspirations".²³ This is particularly pertinent to the leakage position for Anglian. The PCL set by Ofwat reflects the challenging demands of Anglian's WRMP, but the cost allowance (particularly on base) to deliver these falls far short of what is required.
- (32) BfW also highlights the need for holistic decision-making, referencing the impacts of a shortfall in leakage delivery impacts in the effectiveness of behaviour change schemes.²⁴ Again, this is highly relevant for the Anglian region, given the necessity to deliver both significant leakage and water efficiency demand reductions within AMP7.
- (33) Anglian also notes specific support from BfW for the additional allowance for the smart meter programme. Anglian notes that BfW agrees that it is important that base expenditure is not double funded. While Anglian agrees with this principle, it has highlighted issues²⁵ with the CMA's approach, particularly considering an asymmetric cost sharing rate.

3 Leakage

- (34) Ofwat's response to the PFs wrongly claims the industry leakage improvement delivered in 2019-20 is a result of the regulatory challenge the sector to improve and reflects what can be achieved absent additional funding.²⁶ Anglian considers it misleading to attribute the reduction (7%) purely to the regulatory approach for AMP7, absent of placing this reduction in context. This reduction, at least in part,

²² CEF, PF Response, page 1.

²³ Blueprint for Water, PF Response, page 2.

²⁴ *Ibid.*

²⁵ AWPF response pages 37-40.

²⁶ See e.g. Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.20.

will have been a recovery from the increase in leakage resulting from the Beast from the East freeze/thaw event, rather than a genuine longer-term sustained "reduction" in leakage. This has required a significant increase in base expenditure (repairs) by Anglian, far greater than what is implicitly allowed in modelled base cost. Continued base expenditure at a level above the modelled allowance would be unsustainable.

3.1 Base

- (35) Ofwat's assumption that there was a funded opportunity to drive down leakage further prior to the 2018 freeze-thaw event²⁷ is incorrect on two counts. Firstly, for Anglian, no funding for leakage reduction was allowed in AMP6: all enhancement expenditure was shareholder-invested at risk. Secondly, before the 2018 freeze-thaw event, Anglian was on track to deliver a 172MI/d leakage level in AMP6. So even if there was funding to deliver 172MI/d by the end of the AMP, the need to reduce leakage further ahead of 2018 would have required prior knowledge of the freeze-thaw event. It is therefore incorrect to state that Anglian had a funded opportunity to drive down leakage before the 2018 freeze-thaw event.
- (36) Ofwat suggests that a previously submitted report on soil types did not draw conclusions regarding the exposure of Anglian to leakage risk, and focussed on a subset of factors that impact on leakage.²⁸ Responding to the PFs, Dr Tim Farewell submitted an additional report focussing on various regional factors including soil types, pipe material, climate and soil moisture deficit. It compares Anglian's region's exposure to these relative to other parts of the UK. Anglian has also presented evidence of the impact of population density (in a follow up to Anglian's hearing) and existing frontier performance on leakage. Ofwat's assertion that Anglian has been selective in the factors it has examined is not supported by evidence produced by Ofwat identifying alternative regional factors that have a beneficial impact on Anglian's ability to manage leaks and serves as an example of a disproportionate rationale for not accepting company evidence against an unjustified counterfactual, which in Anglian's case as the frontier on leakage, does not exist.
- (37) Ofwat suggests there is limited benchmarking of leakage costs.²⁹ However, in its recent RFI response Ofwat accepts there are limits to the ability to perform such comparisons.³⁰ Anglian agrees with this point to an extent. However, fundamentally Ofwat fails to recognise that decisions on leakage investment are driven by securing supply demand balance, and by factors outside of management control (e.g. population growth, restricted abstractions driven by sensitive watercourses), not simply a company choice to go harder on leakage.
- (38) As the frontier company, and with no consistent reporting of leakage costs across the industry, the ability to externally benchmark base costs is very limited. Despite this, Anglian considers its base cost to be efficient: the cost adjustment is based on historical actual costs, and Oxera's analysis shows that no other company has achieved Anglian's leakage levels at a lower unit cost.³¹ The industry should work with Ofwat to address the reporting of leakage costs ahead of PR24. Ofwat also notes Anglian's reference to the impact of the Beast from the East on base costs, but not the reduction of costs from periods of benign weather. As raised in Anglian's PFs response, severe weather events in 2018 had a significant impact on base costs, however, these costs did not inform Anglian's base cost adjustment claim ("CAC"). The CAC is therefore likely to be negatively skewed by costs from years with benign weather, adding a significant base cost challenge to Anglian in AMP7.

²⁷ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. A3.59.

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ For example - Ofwat response to RFI020 – *"The CMA is seeking more granular information on companies' leakage costs to allow more granular benchmarking of costs. We note it may be difficult to benchmark such granular information"*

³¹ See Oxera Report on Leakage Cost Adjustment Claim, figure 4.1 (PF015).

- (39) Ofwat states that the Demand Management Options report does not provide evidence of the efficiency of options. This report was to help demonstrate Anglian's option development, not to provide evidence of the cost efficiency of options. Anglian has provided separate evidence of the efficiency of costs based on its robust internal cost library, and the challenges it has applied to its leakage enhancement costs including catch up and frontier shift.³²

3.2 Enhancement

- (40) Ofwat queries how the level of activity and costs has been identified for each area of leakage activity.³³ Anglian has provided further details on this in response to questions 1 and 2 of RFI020. As noted in that response, the CMA should be cautious in making direct comparisons between companies on the cost and activities associated with each line of expenditure. For example, active leakage control ("ALC") repairs are a more effective way to reducing leaks at higher levels of leakage, but is less effective when leakage levels reduce, hence Anglian not having any ALC repair costs within its enhancement expenditure. Anglian's leakage programme is not driven primarily by lowest cost options per MI across the region as a whole, but by addressing water resource deficits within specific zones in the region to ensure security of supply, which can be more costly.
- (41) Ofwat raises that Anglian has not changed its unit cost forecast to reflect a higher level of AMP6 outturn leakage than it was originally expecting.³⁴ For the avoidance of doubt, Anglian still needs to deliver the level of leakage reduction required by its WRMP, regardless of the outturn level of leakage at AMP6. Due to the extreme weather events of 2018, Anglian's leakage is higher than anticipated when its business plan was developed. Whilst this has increased the starting point for leakage reduction in AMP7, it has also increased the leakage reduction required in AMP7 by c.10MI/d. Anglian has not requested additional funding from customers to deliver this reduction, thus adding a significant level of stretch to Anglian's AMP7 leakage enhancement challenge.
- (42) Ofwat also disputes the unit rate of Anglian's enhancement leakage expenditure, suggesting that there is overlap between a unit rate of £1.7m/MI/d which Ofwat applies between 193MI/d and 172MI/d and a unit rate of £3.3m/MI/d which Ofwat applies between 182.4MI/d and 159.1MI/d.³⁵ There are a number of significant shortcomings to Ofwat's argument:
- (i) Whilst it references £1.7m/MI/d as unit cost, Ofwat made no allowance for enhancement at PR14. Shareholders funded all leakage reduction costs at risk, investing £27m over the AMP, and recovering only £17m of this through the ODI mechanism;³⁶
 - (ii) Ofwat uses forecast rather than actual unit costs. The actual costs show a 10MI/d reduction was achieved in AMP6 at a cost of £27m. The unit rate therefore is £2.7m/MI/d, and applies to performance down to 182.4MI/d, not 172MI/d;
 - (iii) Anglian is forecasting that its enhancement expenditure will deliver a leakage reduction of 30MI/d, not 23.3MI/d.³⁷ 23.3MI/d reflects the expected leakage reduction in the network, a further 6.7MI/d is to be delivered through smart metering. Suggesting that the network leakage reduction only applies to the initial 23.3MI/d reduction from 182.4MI/d to 159.1MI/d, and smart metering applies to reducing leakage below 159.1MI/d is misleading, and artificially increases Ofwat's suggested overlap of leakage benefit between AMP6 and AMP7.

³² *Ibid.*

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ See also, AWPf Response, Chapter F: Leakage, Section 4.5.

³⁷ See also AWPf Response, para. 268.

- (iv) It is clear therefore that a £2.7M/MI/d unit cost applies to leakage reduction in AMP6 (reducing leakage to 182.4MI/d), and £3.3m/MI/d applies in AMP7 to reducing leakage below 182.4MI/d. There is no overlap in the ranges of leakage reduction that these unit rates apply to. Anglian has highlighted that there is a rising marginal cost of leakage reduction as the level of leakage reduces, and Ofwat recognises the link between performance and costs in its PFs for Yorkshire Water.³⁸ There is therefore no sound basis in Ofwat's analysis derivation of an alternative unit cost of £2.6m/MI/d, rather than Anglian's unit cost of £3.3m/MI/d.

4 Dealing with STW growth expenditure

- (43) In Anglian's PF response, the Company agreed with the CMA that growth at water recycling centres was a material cost item and should be covered by an uncertainty mechanism.³⁹ It noted this was a pragmatic solution, but departed from more granular population-based approaches.
- (44) Anglian notes Ofwat's concerns regarding the CMA's proposal in the PFs, but believes many are overstated. These are discussed further below. Anglian does however welcome Ofwat's counter-proposal to the CMA.⁴⁰
- (45) Ofwat's counter-proposal aligns with the mechanism Anglian proposed to Ofwat earlier during PR19,⁴¹ where Anglian outlined how such a mechanism would work, and to the CMA.⁴² Anglian notes that the CMA has requested information from Ofwat on the proposal and Anglian would welcome the opportunity to comment on Ofwat's response. Anglian believes that such a mechanism is proportionate to the uncertainty risk it seeks to manage.
- (46) As part of its updated totex for growth submitted to the CMA in May 2020, Anglian outlined how its revised totex figures would influence the baseline and unit rate of the mechanism.⁴³ Anglian notes that, based on company business plan data, its unit rate is more efficient than the industry average. The forecast of population growth, its geographic mapping to Anglian's catchments and assets, and the associated expenditure requirements to meet that growth were assured by Jacobs Engineering Group.⁴⁴
- (47) This means that the relevant baseline and unit rates for Anglian under Ofwat's counter proposal already exist and are ready to be implemented, should the CMA be minded to alter its approach in the Redetermination in line with Ofwat's proposal.
- (48) Overall Anglian prefers this approach, which is more closely linked to the key driver of costs, population growth. Anglian also sees the CMA's PFs proposals as a viable option.

4.1 Ofwat's analysis of over-funding

- (49) A key part of Ofwat's critique of the CMA's proposals is that they will over-fund companies.⁴⁵ Anglian strongly disagrees that this is the case for accommodating growth in its region. Anglian highlights the following issues with Ofwat's assessment, which:

³⁸ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. A3.45 – "As Yorkshire Water is one of the poorest performers on a comparative basis, we would expect it to have one of lowest marginal costs in the industry, closer to the upper quartile unit cost value, if it were efficient in its expenditure."

³⁹ AWPf Response, para. 154.

⁴⁰ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, paragraph A2.45

⁴¹ Anglian DD Representation, sections 10.6.6-10.6.8 (SOC168).

⁴² Anglian, Statement of Case, para. 721.

⁴³ Updated Growth Data Table Commentary, para. 1.32 (REP35).

⁴⁴ Growth Technical Assurance Report (REP36).

⁴⁵ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, Table A2.1.

- (i) Ignores the fact that the PFs leave Anglian underfunded for the ONS forecast level of growth. Even with additional revenue from the CMA's proposed uncertainty mechanism, Anglian still faces a shortfall of £111m.⁴⁶
- (ii) Assumes that growth at water recycling centres can be accommodated by a fixed per connection unit rate. Unit rates are not fixed and the key driver of investment at water recycling centres is population growth rather than the volume of connections.
- (iii) Applies cost-sharing in isolation to the additional costs for water recycling treatment enhancement (estimated at £64m), when in fact cost sharing would apply across the wastewater network plus price control, with a total value of £3.1bn.⁴⁷
- (iv) Contains errors in its calculation for the first row of table A2.1. It calculates the increased investment cost based on Anglian's revised forecast of connections, but the increased revenues based on Anglian's (higher) business plan forecast.

5 Botex: Use of 2019/20 industry data

- (50) All the disputing companies proposed that the CMA adopt Ofwat's principle of basing its cost assessments on the latest data and update its base models with the 2019/20 data that has become available during the course of the redetermination. Ofwat made some comments on this proposal in its response to the PFs⁴⁸ and expanded on these in its response to RFI019. Anglian responds to each of Ofwat's comments below:

5.1 The data have not been subject to a full quality assurance yet⁴⁹

- (51) Ofwat has always made clear that responsibility for the quality of published data lies with companies' Boards. In an information notice in April 2020 Ofwat stated that "each company is responsible for implementing assurance procedures to make sure they meet all of their legal and regulatory obligations".⁵⁰ The same Information Notice stated that "where evidence emerges that a company is not providing assurance or may not be complying with its obligations and commitments we will take appropriate action to protect customers".⁵¹ Companies are in no doubt that sanctions may follow if they fail to provide reliable data.
- (52) Notwithstanding, Ofwat applies its own quality assurance processes to APR data. Companies published 2019/20 APRs, the source of all modelling data, on 15 July 2020, at which point Ofwat's quality assurance process could begin. If Ofwat has reason to question data which a company has published it issues a formal query to ask for explanations of the apparent anomaly or, if an error has been made, corrected figures. The progress of Ofwat's quality assurance process is therefore evident from the queries it has issued.
- (53) Table 1 below shows when Anglian received queries relating to its 2019/20 APR:

⁴⁶ AWPf Response, para. 153.

⁴⁷ Based on Anglian's draft determination investment plan.

⁴⁸ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, paras. 2.45-2.47.

⁴⁹ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.46.

⁵⁰ Ofwat, IN 20/03, Expectations for monopoly company annual performance reporting 2019-20, page 7 (April 2020) available [here](#).

⁵¹ *Idem*, page 7.

Table 1 Anglian queries from Ofwat relating to its 2019/20 APR

	July			August					September				October				November
Wk beg	12	19	26	2	9	16	23	30	6	13	20	27	4	11	18	25	1
No.	1	1	1	2	1	0	1	0	1	1	1	0	0	0	0	0	1

- (54) This shows that the quality assurance process started in July (Anglian received its first query on 16 July, the day after it published its APR). And it suggests that the process is now complete, as no query had been issued since September, until Anglian received a non-material query on 6 November. While queries are not published, Anglian understands the experience of other water companies with APR queries to be similar to its own.
- (55) Ofwat reproduces information about companies' financial and service performance, drawn from the APR, in an annual Service Delivery Report. On 9 October 2020 Ofwat told Anglian, via email, that it intended to publish the 2019/20 Service Delivery Report "in November". Furthermore, Ofwat sent Anglian the data it intends to publish about Anglian in that report to allow for accuracy checks. These data included numbers used in base models, such as expenditure, length of water mains and numbers of connection. It would seem unlikely for Ofwat to be planning imminently to publish a key report on company performance, and to circulate draft numbers for that report, if it had still to complete quality assurance processes.
- (56) In conclusion, Anglian believes Ofwat's processes for quality assuring companies' APR data have been in train for 16 weeks and are now complete.

5.2 Non-section 185 diversions costs were not excluded from Bristol Water's dataset⁵²

- (57) Anglian compiled its own modelling dataset from companies' 2019-20 APRs and provided it to Oxera to update the CMA's base cost models. Non-section 185 diversions costs are not separately reported in APRs. Anglian used the forecasts for these costs that companies provided in the final versions of PR19 business plans and excluded them from the dataset. These costs are not significant: over the period 2012/13 to 2019/20, non-s185 diversions costs comprised 0.12% of industry water base costs and 0.21% of water recycling base costs. The error in Bristol Water's dataset, which was not replicated in the dataset used by Oxera for Anglian and the other disputing companies, will not have materially affected the conclusions of Bristol Water's analysis.
- (58) Ofwat says that it will take two weeks to provide a modelling dataset.⁵³ For information, compiling the 2019/20 modelling dataset took one person at Anglian three days. The expanded files WW1 and WWW1 which included these data were within Oxera's datapack that Anglian submitted as source files on 30 October 2020. Anglian would be pleased to provide the intermediate files used to populate expanded files WW1 and WWW1.

5.3 Expenditure in 2019/20 included significant investments brought forward from 2020-25 as preparation to meet performance commitments in AMP7⁵⁴

- (59) The tendency for expenditure to rise and fall over the five years of a price control period has long been seen as a source of inefficiency. The problem was deemed sufficiently serious for Defra to make the task of addressing it one of its ten strategic priorities for Ofwat in 2013.⁵⁵ Ofwat has introduced

⁵² Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.46.

⁵³ Ofwat response to RFI019, received 2 November 2020.

⁵⁴ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.46.

⁵⁵ Defra's strategic policy statement to Ofwat, para. 2.13 (March 2013).

mechanisms into the price review process to encourage 'early start' expenditure but, outside of these, companies still have the option of advancing or deferring expenditure. In doing so, they will weigh up the rewards or penalties that arise from the cost performance framework of the previous price control period against the risks and opportunities presented by the service performance framework of the following period. Faced with challenging performance commitments in AMP7 and the biggest enhancement programme since privatisation, it is not surprising if some companies chose to make an early start in 2019/20. This is particularly true of the 'fast-track' companies, for whom the rewards of fast tracking include "*procedural benefits from receiving an early draft determination in March or April 2019 ... helping to accelerate the delivery of company plans*".⁵⁶

- (60) Early start AMP7 expenditure may not be confined to 2019/20. The quote Ofwat extracts from Anglian's APR in response to RFI019 refers to investment "in years four and five". Other companies may have also made additional investment in year four (2018/19), yet data from this year was added to the modelled data panel by Ofwat between DD and FD.
- (61) It is not practical for all expenditure to fall neatly within the five-year period to which it is deemed to apply. Major construction projects have long lead times before ground is broken and long tails post-delivery to deal with costs such as site break-down, landscaping, snagging and compensation payments. Post-delivery costs associated with AMP6 schemes (many of which were scheduled for completion by 31 March 2020) form material proportions of expenditure in 2020/21 and 2021/22. It would be inconsistent to ignore 2019/20 expenditure as it might include some "AMP7 expenditure" without recognising that a material proportion of "AMP6 expenditure" was still to be incurred.
- (62) It is because levels of expenditure can vary quite significantly between years that a single year is not used for the purposes of assessing future costs. Using a panel of data spanning a number of years for cost modelling minimises the impact of atypical years and any discontinuities introduced by price control period boundaries. The greater the number of years in the panel, the more the impact of inter-year variations are lessened.
- (63) Anglian notes that the seven-year panel Ofwat initially used for its IAP models was extended to eight years for the FD with the addition of 2018/19 data. Adding 2019/20 data extends this panel to nine years. The observations from additional years make a progressively smaller proportion of the total and have a successively smaller impact on modelling output. Anglian notes that the impact of modelling with 2019/20 data would likely have been greater had the oldest two years been discarded and a seven year panel retained.

5.4 FD allowances were calibrated against forecasts of base costs for 2020-25⁵⁷

- (64) Anglian understands this to mean that the base models Ofwat used at PR19 were selected on the basis of how well the allowances they forecast compared with the forecasts of expenditure that companies quoted in their plans. This contrasts with Ofwat's PR19 reports which stated that models were selected on the basis of objective criteria such as engineering rationale, goodness of fit and the range of efficiency scores. In its PFs response Ofwat appears to be saying that it might have chosen different models had incorporation of an additional year's data into its preferred models produced base allowances that were higher than the forecasts of an acceptable number of companies.
- (65) Leaving to one side what this approach indicates about the objectivity of Ofwat's approach and the reliability of its PR19 reports, Anglian notes that the additional allowances calculated by Oxera from incorporating 2019/20 data into the CMA base models still leaves itself, Yorkshire and Northumbrian with lower base allowances than they forecast in their plans.

⁵⁶ PR19 Final Methodology, page 245 (SOC314).

⁵⁷ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.47.

6 Metaldehyde

- (66) Ofwat's response proposes no additional allowance for Anglian for metaldehyde.⁵⁸ Ofwat fails to differentiate between the components of Anglian's proposed investment driven by investment in treatment and the proposed investment in catchment management.⁵⁹
- (67) As set out in Anglian's PF response, Anglian proposed to return £50m of the CMA's PFs allowance.⁶⁰ It also proposed, based on materiality of expenditure, to remove the proposed clawback mechanism.⁶¹ Anglian believes this is the right approach.

7 Bioresources

- (68) Anglian supports the CMA's conclusion that the evidence presented in its Statement of Case and subsequent submissions demonstrate that:
- (i) trading capacity within the bioresources is currently highly constrained, despite Anglian's efforts to develop the market and;
 - (ii) on a Whole Life Cost basis, including the full replacement/refurbishment and operational costs, the additional capacity at Whitlingham is the best value option for customers. This is set out in detail in Anglian's to RFI008, question 28.
- (69) Anglian strongly refutes Ofwat's assertion that providing an allowance to develop capacity at Whitlingham would foreclose the Bioresources market.⁶² Anglian is a market leader in developing and participating in emerging markets.⁶³
- (70) As previously evidenced to Ofwat and latterly the CMA, Anglian has tested the market in developing its plans, however without further reform to facilitate co-digestion there remains no satisfactory long-term trading opportunities it is unlikely that other providers can meet the rising demand across Anglian's region. Furthermore:
- (i) Ofwat's suggestion that providing a cost allowance represents poor value for money for customers is unsupported with any further evidence.⁶⁴ Anglian addressed these points regarding its cost allowance in its response to RFI008, question 28.
 - (ii) Ofwat implies the location was selected to frustrate trading with neighbouring WaSCs.⁶⁵ Anglian has explained the basis for selecting Whitlingham in its response to RFI012, question 9.
 - (iii) Ofwat's suggestion that "*it does not matter precisely where [that] capacity is constructed*" on the basis that Anglian transports a significant proportion of sludge by road is spurious and ignores previous evidence provided by Anglian on the efficient location of further sludge capacity.
 - (iv) Anglian disagrees that the PFs are internally inconsistent.⁶⁶ The circumstances surrounding Yorkshire Water's pursuit of a market-based option are specific to Yorkshire and should not influence setting the correct cost allowance for Anglian.

⁵⁸ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes – response to the CMA provisional findings, Para 2.44, page 13 and Annex A4.

⁵⁹ Anglian RFI014 Response – Q16 presents the breakdown of the previously proposed metaldehyde investments totalling £63m.

⁶⁰ AWPf Response, Chapter E: Section 5.1, page 42.

⁶¹ AWPf Response, Chapter E: Section 5.2, page 43.

⁶² Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, para. 2.43.

⁶³ SOC001 Chapter 11 – The Role of Markets, Incentives and Behaviours, specifically 11.2.

⁶⁴ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 51.

⁶⁵ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 52.

⁶⁶ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 52.

- (v) Ofwat's suggestion that Anglian's growth forecasts are overstated by reference to WRMP09 is self-serving.⁶⁷ Anglian discussed the driver for enhancement expenditure in its response to RFI012 question nine. As Ofwat is aware, more recent current growth forecasts, as highlighted in figure 4-4 of the CMA's PFs, demonstrate Anglian's WRMP14 forecast was very accurate compared to actual. As expected, in order to reflect the latest information available, Anglian has revised its growth forecast in the period post-Business plan 2018 submission. This has resulted in a reduction in forecast of connections during AMP7, however forecast of population growth (and key determinant of investment STW capacity) has in fact increased.⁶⁸

⁶⁷ Ofwat, Reference of the PR19 final determinations: Costs and Outcomes - response to CMA provisional findings, page 53.

⁶⁸ Anglian, Statement of Case, Table 5, page 84.

Chapter E: Financing

1 Overview

- (71) Anglian broadly supports the CMA's approach to estimating the cost of capital and assessing financeability. In particular, Anglian welcomes the CMA's recognition of WACC as the key determinant of financeability, its adherence to rating agency methodologies, and its acknowledgment of the importance of maintaining strong credit ratings and incentivising long-term investment in the sector.
- (72) Anglian was however very disappointed to see in Ofwat's PF response that Anglian's proposals to Government for potential extra investment in support of a Green Recovery were cited as evidence that the allowed return in its FD was in fact sufficient to incentivise investment.⁶⁹ Ofwat has misrepresented Anglian's proposals, made in good faith in response to a specific request from Ministers, and which are contingent on a funding solution being found. This caveat was clearly stated in Anglian's response to the Minister's request for proposals which referenced the need for agreement as to "*how these projects can be funded, financed, and integrated into our settlements for AMP7 and AMP8*".⁷⁰
- (73) On **financeability**, Ofwat's PF response ignores the fact that the underlying reason why the FD is inadequate and resulted in financeability constraints is that it nearly halved the allowed returns relative to PR14, from 3.74% to 1.96%.
- (74) Ofwat seems to accept that changes to PAYG will not maintain the minimum financial ratios consistent with the target credit rating, but now criticises the CMA for failing to consider NPV neutral alternatives to fixing financeability problems.⁷¹ Ofwat's reasoning is flawed: NPV neutral fixes will not create a notional equity buffer for companies in the future, and hence will not help with achieving target ratings. This point is well understood by credit rating agencies. The existence of such acute financeability problems provides *prima facie* evidence that the WACC was set too low. This evidence is a relevant cross-check on the parameter-by-parameter analysis of the components of WACC that Anglian submitted, which also showed why the WACC was set too low.
- (75) Ofwat criticises the CMA for provisionally deciding on a WACC allowance greater than the FD, but fails to acknowledge that the CMA's PFs already represent a significant reduction (about 30%) to the allowed WACC relative to PR14. Ofwat's response deliberately masks the reality that the PFs deliver significant bill reductions relative to PR14 and leaves the notional company just financeable, achieving ratios right at the bottom end of the Baa1/BBB+ range. Moreover, as set out in Anglian's PF response, the impact of the PFs is that the notional company has essentially no risk buffer (just c.£5m per annum) to maintain this rating and faces significant downside risk. Not only is Ofwat silent on these realities, it also makes a number of unfounded criticisms of the CMA's analysis on the components of the WACC.
- (76) On the **cost of equity**, Ofwat has criticised the CMA for its perceived "novel" approach. It fails to recognise that the main factor for the significant reduction in cost of equity from PR14 to PR19 was Ofwat's own deviation from previous approaches, which followed the publication of the UKRN Paper by Wright et al (2018). PR19 saw Ofwat depart from regulatory precedent (prior to the 2018 UKRN paper) and make many changes in methodology, including the adoption of a reconstructed and unreliable historical CPI series to deflate historical market returns. This was a departure from its approach at previous reviews, as well as the CMA's previous appeals (e.g. *NIE (2015)* and *Bristol (2015)*).

⁶⁹ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, para.2.19.

⁷⁰ Letter from Peter Simpson to Rebecca Pow MP, copied to Rachel Fletcher at Ofwat, and senior staff at the Environment Agency, CCW and DWI (18 August 2020).

⁷¹ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, paras. 3.69-3.72.

- (77) Similarly, in its response Ofwat is suggesting a move to a spot estimate of the risk free rate using ILGs, which again is neither supported by the requirements of the capital asset pricing model nor consistent with past approaches by regulators.
- (78) Ofwat also appear to suggest that the CMA's decision to "aim up" is driven by its financeability assessment. However, the CMA's approach at PFs was not to aim up or down in setting individual credit metrics, and it adopted differing approaches for cost of equity and cost of debt. The CMA noted that the estimate of the cost of equity will be subject to greater error than the estimate of the cost of debt and there was a need to aim up to reflect such uncertainty.⁷² Further, as Anglian stated in its PF response, the CMA's cost of equity range is wide and does not reflect only the most robust data from its substantial evidence base. Therefore, when a more balanced assessment of the evidence is made, the CMA's point estimate is actually in the middle of the appropriate range and does not rely on aiming up.⁷³
- (79) On the cost of embedded debt, Ofwat has characterised the CMA's PFs as over-funding the cost of embedded debt across the sector based on a misleading comparison of the CMA's allowance with the cost of debt implied by the Annual Performance Reports ('APRs'). The APR data is not prepared on a technically correct basis for estimating the cost of embedded debt across AMP7. As a result, the APR data is misleading, under-states the actual cost of debt, and not comparable to the regulatory allowance for embedded debt. Ofwat has recognised this in the past – it has made specific adjustments to exclude distortive items when calculating the cost of debt under its own balance sheet approach. As a result, Ofwat's proposed approach in the response is not consistent with the methodology it has applied throughout the PR19 process.
- (80) Ofwat asserts that a 20Y trailing average is too long because the proportion of the debt portfolio attributable to the 2000-5 period is overstated due to the inclusion of what so-called non-operational finance. Ofwat's analysis of non-operational financing is incomplete and relies on unrealistic assumptions so should not be taken into account.
- (81) Ofwat's proposal for an RCV-weighted trailing average period is not appropriate for estimating the cost of debt for the notionally financed company. Establishing a link between sector-wide RCV growth – which companies cannot control at the sector level – and the cost of debt does not imply right incentives as it is based on factors (i.e. sector-wide RCV growth) which they cannot control and exposes companies to significant risks of a mismatch between their (efficient) costs and regulatory allowances in the future. Notwithstanding this, Ofwat's modelling of the RCV-weighted trailing average period is flawed and unlikely to represent a suitable proxy for the profile of notional company debt issuance.

2 Ofwat's criticisms of the CMA's assessment of the cost of equity

- (82) Ofwat's evidence from its academic advisers Mason and Wright ("**M&W**") is actually more in line with Anglian's advisers in terms of the correct approach to beta. Empirical analysis using the approach recommended by M&W supports asset betas in line with or materially above the CMA's estimates, with the daily asset beta being 0.36. This compares to the CMA's range of 0.27-0.32, Ofwat's point estimate of 0.29 and the CMA's point estimate of 0.31.
- (83) Ofwat and its advisers claim that the RFR estimate should be close to the ILG rate, based on the marginal investors in water being net lenders, rather than borrowers.⁷⁴ This is a surprising assertion with no theoretical foundation; the theoretical literature on the CAPM is stated here for ease of reference.

⁷² PFs, para. 9.665.

⁷³ AWPF Response, para. 383.

⁷⁴ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, para. 5.19.

Under the CAPM, the RFR should be based upon the marginal investor in the market portfolio, not the identity of the marginal investor for the particular asset being priced.

- (84) Ofwat claims that placing significant weight on AAA-rated bonds in its calculation of the risk-free rate is unprecedented in the UK.⁷⁵ This is misleading. Ofwat ignores the fact that the reason why evidence on AAA-rated bonds is required to assess the risk free rate in the CAPM is that Ofwat itself made a significant change in methodology at PR19 by following the UKRN / Wright et al (2018) recommendation to use spot rates on ILGs as a proxy for the risk free rate. This is a significant departure from standard UK regulatory practice of adopting a headroom over the ILGs rate. Furthermore, nothing in CAPM theory or empirical evidence states that the risk free rate should be based on spot rates of ILGs. Recognising a headroom over spot rates is a standard and appropriate practice in regulation.
- (85) There is no new evidence or argumentation from Ofwat on TMR.
- (86) Accepting the CMA's cost of equity ranges as a given, Anglian disagrees with Ofwat's critique of the CMA's approach and rationale for aiming-up, for three main reasons:
- (i) First, it should not be controversial that the asymmetry in the PFs must be priced into the WACC (if the asymmetry itself is not addressed). Therefore, the CMA's 10-20bp RORE downside (based on ODIs only) should be a floor to aiming-up on the cost of equity.
 - (ii) Second, Anglian disagrees with Ofwat's claim that the parameter ranges are normally distributed and consider a uniform distribution assumption to be the most appropriate for the CMA's ranges. However, even if a normal distribution assumption is correct, Europe Economics has materially underestimated the standard deviation, hence its surprising conclusion that the 75th percentile of the range is still closer to the mid-point.
 - (iii) Third, the CMA is not aiming up to incentivise new or more investment, as most of Ofwat's new material on aiming-up assumes, but simply to mitigate the risk of getting the cost of equity wrong because of the inherent estimation error in so many changes in methodology at PR19 (use of CPI deflated series, use of spot risk free rate, etc). The concept of aiming-up to account for uncertainty in estimation is grounded in a body of academic literature and regulatory precedent. Indeed, the UKRN paper and Ofwat's latest submission from M&W, continue to support the concept of aiming-up to account for uncertainty.
- (87) The attached KPMG report sets out further details on the need to aim up on the cost of equity.⁷⁶
- (88) It is also worth noting that NATS is not the most appropriate comparator since the CMA had account for certain specific circumstances of the company (i.e. UK government has a 49% stake, gearing is below 30%, a credit rating underpinned by the promise of implicit government support) which do not apply to the water industry. Further, Ofwat's comparisons are with the NATS PFs i.e. an interim report which were put out for consultation and cannot be characterised as definitive findings from the CMA. Due to the significant impact of Covid-19 on the sector, these PFs were confirmed in the final report albeit for a temporary period and did not reflect the responses to the PFs.⁷⁷
- (89) Ofwat's new top-down evidence on the cost of equity from other regulatory regimes in Europe does not suggest that the CMA's cost of equity is too high. These are not like for like comparisons.

⁷⁵ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, para. 5.16.

⁷⁶ KPMG, A Reply to Ofwat's PFs Response, Sections 3.4- and 3.5 (PFREP001).

⁷⁷ The CMA's Final Report of July 2020 merely confirms the PFs, without accounting for the industry response. However this is only for a temporary period (i.e. not more than 3 years) until a more comprehensive reworking of the price control can be undertaken, accounting for the impact of Covid-19 on the industry. See Yorkshire Water, Response to the CMA's provisional findings of 29 September 2020 available [here](#), paras. 3.4.7-3.4.9.

3 Ofwat's criticisms of the CMA's approach to cost of embedded debt

- (90) On the **cost of embedded debt**, Anglian makes three high level observations. First, Ofwat makes basic errors in its assessment: in criticising the implementation approach by the CMA of its 20-year trailing average method, Ofwat computes a significantly lower cost of embedded debt than the corrected calculated allowance using a sector-wide RCV-weighted index which is not appropriate for setting the allowance for the notional company and is based on flawed modelling. Second, Ofwat's response is at times misleading, for example when it criticises the CMA for not examining the current APR evidence. Third, it makes unfounded criticisms of Anglian's analysis in relation to the outperformance wedge and generally lacks a balanced assessment of the evidence in reaching its conclusions that the 4.81% allowance in the CMA's PFs is too high an allowance. Each of these points is explained in turn below.
- (91) Ofwat rejects the CMA's approach of adopting a 20Y trailing average approach to estimating the cost of embedded debt. It goes on to suggest that even if the 20Y trailing average approach were correct, there are errors in its implementation, including the fact that the cut-off date of end of July 2020 should be replaced by 31 March.⁷⁸
- (92) As set out in detail in its PF response, Anglian believes that the 20Y trailing average approach is appropriate as it recognises the importance of timing of debt issuance and remunerates significant outstanding debt. It is consistent with a 20Y investment horizon and the weighted average years to maturity of the benchmark index. This underpins the recovery of efficient financing costs for the notional company given how market rates have moved across the 20Y investment horizon (see Anglian PF Response, para. 421). Furthermore, the 20Y trailing average is the right policy as it encourages and incentivises long-term financing consistent with the long-term nature of the assets and implies and consistent regulatory policy over time.⁷⁹
- (93) In relation to the method of implementation, Anglian's PF response made the same comments as Ofwat in relation to the adoption of dynamic embedded debt (referred to in the Anglian response as an 'inverse trombone') and the appropriate cut-off date.⁸⁰ Anglian is pleased that Ofwat recognises that these methodological changes to the CMA approach are appropriate. After correcting its own calculations presented in the October 2020 document, Ofwat has subsequently issued an erratum recognising that the correct estimate is in fact not 4.45% (table 4.6 of Ofwat's response October 2020), but instead is 4.95%, in line with Anglian's response, and higher than the CMA's allowance of 4.81%. In their revised wording of paragraph 4.38, Ofwat should have followed the logic of their own argument and argued for a higher cost of embedded debt allowance than in the PFs.
- (94) Ofwat has carried out a high-level review of the 2019/20 Annual Performance Reports ("**APRs**"), which indicates that the average cost of debt across the sector is 4.50%, 31bps lower than the CMA's point estimate for embedded debt (4.81%) in its PFs. This leads to two main points.
- (i) First, Ofwat's use of APR evidence to show that the CMA's embedded cost of debt allowance is too high is selective and misleading, as APR data is not comparable to the regulatory allowance for embedded debt. Ofwat's own Balance Sheet cross-check evidences this (both the figures themselves including swaps and Ofwat's own acceptance that adjustments to reported numbers are required).
 - (ii) Second, Ofwat's suggestion that the APR data can be relied upon appears to be opportunistic, as the reported data is clearly prepared – in accordance with Ofwat's Regulatory Accounting

⁷⁸ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, para. 4.35.

⁷⁹ AWPF Response, para. 421.

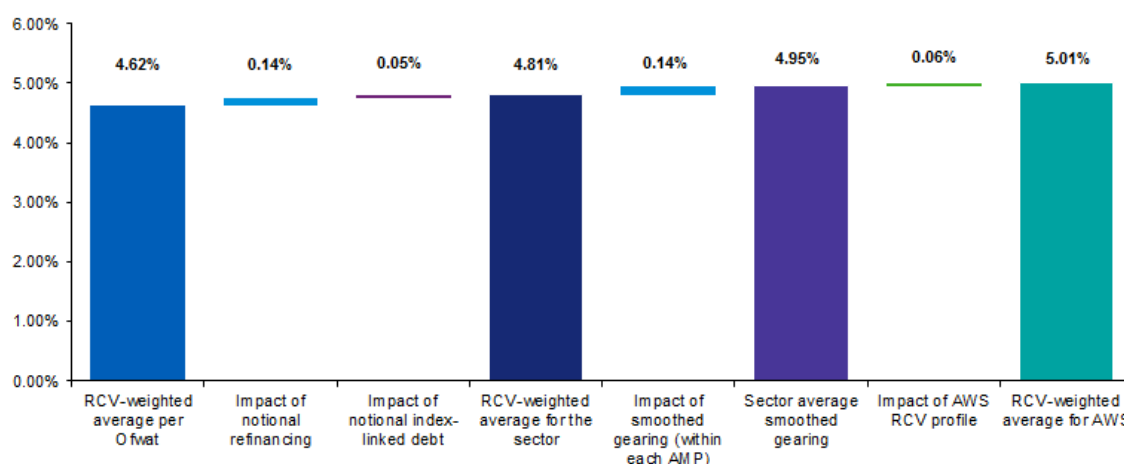
⁸⁰ AWPF Response, Section 5.2.4, page 86.

Guidance – on a basis that is not consistent with the balance sheet cross check that Ofwat applied in the past and used to calibrate its cost of embedded debt allowance.

- (95) Ofwat does not acknowledge derivatives within its embedded debt methodology, but does include them within the APR. Ofwat's suggestion of now looking at APR would imply therefore that the relevant benchmark for the cross-check is the all-in economic cost *including derivatives*.
- (96) Ofwat's new evidence on the index-led approach continues to confuse the Balance Sheet cross-check, which is used to estimate the actual cost of debt across the industry, with the index-led notional approach. These are two separate exercises and should be treated as such.
- (97) Ofwat's challenges to the analysis of the outperformance wedge evidence provided by KPMG on behalf of Anglian are unfounded and rely on a small sample of long-dated bonds. Ofwat's primary concern with the outperformance wedge evidence hinges on two bonds, with tenors which are much longer dated than the iBoxx average, outperforming the iBoxx. This is evidently a very small sample size upon which to draw conclusions. In fact, taking into account the informational value of the full sample, both the KPMG and Ofwat analyses are consistent with the conclusion that there is no material halo effect, when rating and tenor are controlled.
- (98) The attached KPMG report⁸¹ shows that Ofwat's analysis supports the conclusions in the original KPMG analysis, cited by CMA, which finds no halo effect when rating and tenor are controlled for.
- (99) Ofwat's RCV-weighted trailing average assumes that the notional firm was not refinancing any debt for 20 years post privatisation, and that no index linked debt was raised for the notional company. This assumption does not reflect the reality of financial markets or regulatory conditions post privatisation, nor does it recognise the licence change to a rolling 25-year notice period made in 2003. Ofwat's modelling also assumes that changes in notional gearing assumed in previous price controls should be directly reflected in the modelling. However, assumed changes in notional gearing (which has typically ex post been adjusted to reflect trends in actual company structures) should not be applied ex post to adjust the weighting of the trailing average, as this approach would introduce a disconnect between past debt issuance and assign disproportionate weight to individual years.
- (100) When these unsupported and unrealistic assumptions are relaxed, the weighting approach does not materially differ to the simple average (see Figure 1 below). Moreover, using sector-wide actual RCV growth links the notional cost of debt too closely to actual data across the companies. This creates arbitrary winners and losers, and puts too much weight on factors which cannot be controlled by the notional company.

⁸¹ See KPMG, A Reply to Ofwat's PFs Response (PFREP001).

Figure 1 RCV-weighted cost of debt variants (equally weighted)



- (101) Ofwat's analysis of what it deems to be non-operational financing is limited by its assumptions and the sampling methodology applied. For example, Ofwat does not consider the impact of the financing decisions on companies' cost of debt against plausible counterfactual scenarios and only identifies for further testing financing decisions that resulted in year-on-year gearing increases of at least 5%. Anglian has considered several counterfactual scenarios⁸² when assessing the impact of its capital replacement in 2002 on the cost of debt during AMP7 and concluded that the restructuring did not lead to an increase in the cost of debt for Anglian when considered against plausible counterfactual scenarios.
- (102) Overall, Ofwat misrepresents the PFs as over-funding the cost of embedded debt across the sector. The properly calibrated balance sheet cross check implies a cost of debt of 4.95% (14bps higher than the CMA's PF allowance for embedded debt costs), and is consistent with (i) the equally weighted inverse trombone (4.95%); and (ii) the range implied by the adjusted RCV-weighted approach (at least 4.90%). The figure above shows that when Anglian's RCV growth specific adjustment is made, the cost of embedded debt is actually 5.01%.

4 Comments on Ofwat's response to the PFs on opex/capex misallocation

- (103) The CMA agreed with Anglian's arguments of the need to resolve the **opex/capex misallocation**, noting in its PFs that the PAYG rate should be set to be consistent with company proposals.⁸³ Ofwat's response (incorrectly) states that "the CMA is yet to decide on this matter".⁸⁴ The point of principle is established in the PFs, the issue that remains to be resolved is how to give effect to the resolution of the misallocation. Anglian supports the totex approach introduced by Ofwat to help overcome a perceived bias to capital solutions. However, accounting conventions require that opex be expensed and capex capitalised. Anglian is required to report its spend using these accounting definitions and the calculations on financeability need to take this into account, and ensure that determinations reflect correct allowances. Recognising that Anglian is still facing a very significant gap in its Totex requirements, it is essential that the correct opex/capex split is reflected to enable critical in-year opex funding requirements to be met, and to ensure financeability ratios are met.

⁸² These include, for example, a scenario where Anglian did not gear up and instead raised debt in line with notional gearing and asset lives. See Anglian's response on the CMA's RF1017 and KPMG Report Analysis of Anglian's embedded debt position and Ofwat's PR19 allowance for remunerating embedded debt for further detail.

⁸³ PFs, paras. 10.99-10.100.

⁸⁴ Ofwat, Ofwat, Reference of the PR19 final determinations: Fundamental errors of approach – response to CMA provisional findings, para, 2.12.

5 Ofwat's criticisms of the CMA's approach to gearing sharing outperformance mechanism

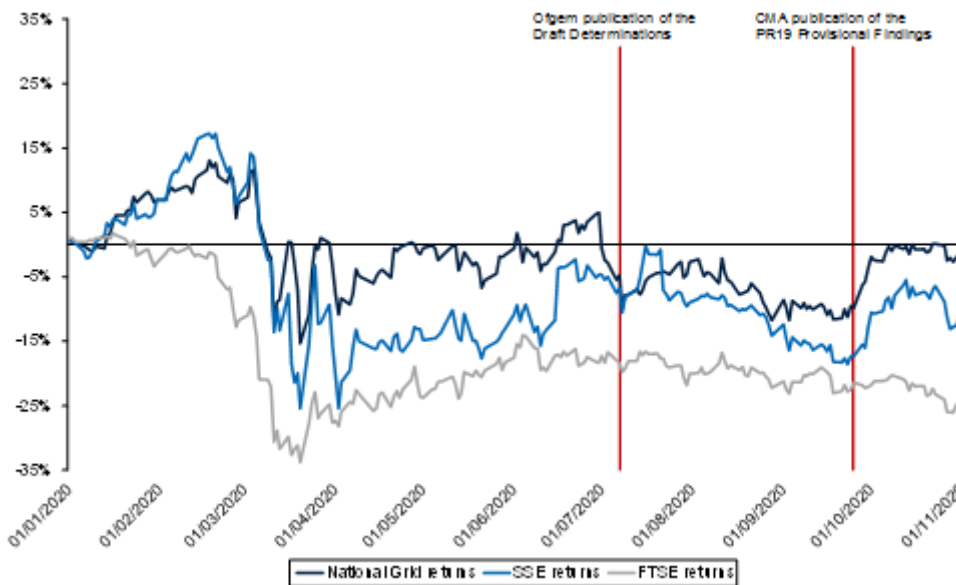
(104) In relation to the **gearing outperformance sharing mechanism**, the Statement of Case and May 27 submission set out Anglian's position in detail.⁸⁵ However, Anglian would like to reiterate that Ofwat has sufficient tools at its disposal to ensure financial resilience. In particular, the recent licence change relating to the regulatory ring-fence (that Anglian has accepted) ensures that any company that could be close to facing financial difficulty would go into a dividend lock-up, thereby protecting its customers. This licence change makes the water sector one of the most secure of any regulated sector.

6 Ofwat's use of share price information in criticising the CMA's approach to financeability

(105) Ofwat claims that current market **to asset ratios** provide useful evidence on the allowed rate of return.⁸⁶ As explained before, evidence from traded market premia do not provide a reliable guide to the cost of equity used by investors in regulated utilities, and the MARs observed for Severn Trent and United Utilities are not representative of other regulated water companies. Therefore, this data is not informative as to where to set the point estimate of the cost of capital.

(106) Similarly, Ofwat uses **share price information** from listed energy companies⁸⁷ to criticise the CMA for not adequately considering relevant cross checks. The chart is highly misleading. As can be seen below when Ofgem's DD was announced, the share price returns of National Grid and SSE showed a downward trend. This could be understood as contributing to addressing what was a significant tightening of the price control relative to previous Ofgem determinations. Ofwat portrays therefore a biased picture of the reality.

Figure 2 Returns of National Grid and SSE and FTSE 100 in 2020



Note: The returns are estimated as percentage changes. The price on the last day trading day of 2019 is used as a base. The Ofgem publication of the Draft Determinations is 09/07/2020 and the CMA publication of the PFs is 29/09/2020.

Source: Oxera analysis based on Yahoo finance data.

⁸⁵ Anglian, Statement of Case, Chapter K: Gearing outperformance sharing mechanism, page 309; Anglian's Reply to Ofwat's response, Part F.3 and Part I.3.

⁸⁶ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, paras. 2.8-2.12.

⁸⁷ Ofwat, Reference of the PR19 final determinations: Risk and Return – response to CMA provisional findings, Figure 2.3, page 18.