

**Anglian Water**

**PR19 CMA Redetermination**

**Working paper response – 2019/20 Data for base cost models**

**Submitted 20 January 2021**

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## 2019/20 data for base cost models working paper response - Overview

### 1 Summary

- (1) The CMA states it is minded not to update the base cost models with 2019/20 data because it concludes it is likely that expenditure in 2019/20 included a substantial amount of expenditure brought forward from AMP7, and the presence of this AMP7 expenditure will introduce bias to model estimates<sup>1</sup>.
- (2) The CMA's conclusion relies on the statements of a small proportion of the industry. In those statements, the relevant companies are imprecise about the targets and timing of their expenditure, and where there are sums quoted those sums are relatively immaterial in the context of total industry base expenditure. Anglian therefore disagrees with the CMA's conclusion that 2019/20 expenditure was likely to include a substantial amount of expenditure brought forward from AMP7. Furthermore, Anglian believes that the decision not to update the base cost models with 2019/20 is therefore disproportionate.
- (3) Anglian agrees that the proportion of AMP6 expenditure incurred in year 5 (2019/20) was unusually high compared to earlier years in AMP6 but explains and evidences why this was the case: namely, that it included a substantial proportion of expenditure deferred from earlier years of the AMP6 period. **Anglian supports this by showing that, in comparison to previous AMP periods, the proportion of AMP6 expenditure incurred in years 1 and 2 was unusually low.** Furthermore, Anglian explains why, based on the significant regulatory changes introduced at PR14, the pattern of expenditure differed in AMP6 from previous AMP periods. The increase in expenditure in the final year of AMP6 is consistent with the case Anglian has persistently made that increased service quality standards - such as those delivered by the end of AMP6 - come with an attendant increase in cost.
- (4) Anglian's analysis demonstrates that bias will be introduced into the forecasts produced by cost models that are not updated for 2019/20 data because 2019/20 was the year in which the greatest proportion of AMP6 expenditure was made. In the absence of the 2019/20 data, total AMP6 expenditure is not accurately represented. Furthermore, by excluding 2019/20 data, the CMA is placing greater weight on the early years of expenditure in the data panel (e.g. 2012/13 - 2014/15) which pre-date AMP6. The nature of expenditure in these years has not been scrutinised in any detail and yet it is proposed that they are more representative than the most recent year of industry expenditure to inform future allowances.
- (5) Anglian supports the CMA's proposals on the methodological issues associated with updating the models.

### 2 Request to the CMA

- (6) In the absence of compelling evidence that 2019/20 expenditure included a sufficiently material proportion of AMP7 expenditure to justify disregarding that year's data from the models, the advantages of updating the models significantly outweigh any disadvantages. On that basis, the CMA's preliminary conclusion in its working paper to exclude the data is disproportionate. **Anglian requests that the CMA updates the base models with 2019/20 data for the final redetermination. In doing so, the CMA should apply the methodological approaches proposed in its working paper<sup>2</sup>.**

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<sup>1</sup> Paras 64 to 65

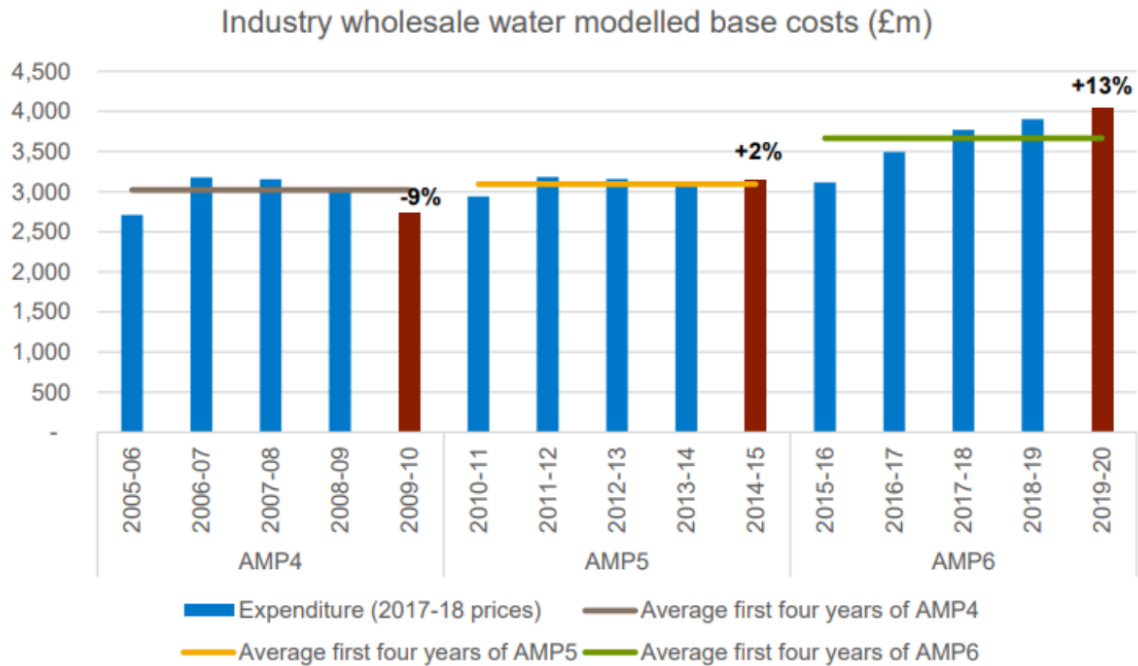
<sup>2</sup> Para 67

## 2019/20 Working paper – Main response

### 1 Anglian agree that expenditure in 2019/20 in water was atypically high.

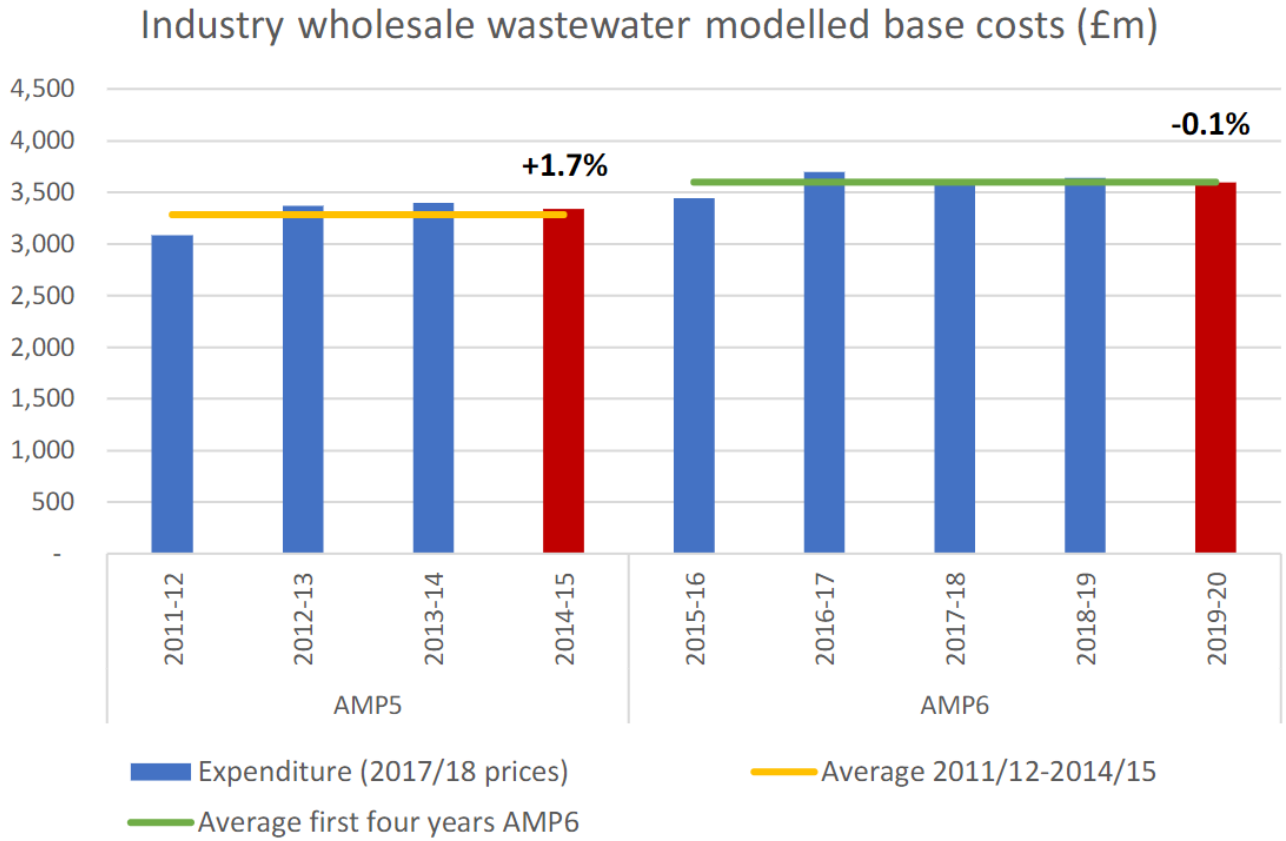
- (7) In Figure 1 of the working paper the CMA replicates the chart from Ofwat's *Reply to responses to the Provisional findings – costs and outcomes*. This chart shows the total annual industry modelled base water expenditure over the last three AMP periods. It highlights that, when compared to average expenditure incurred in the first four years, expenditure in year 5 for AMP6 was higher than in the previous two periods. Anglian does not dispute that the pattern of expenditure in AMP6 is very different from the previous two periods and that if the pattern from those previous periods is regarded as normal the level of expenditure in 2019/20 is atypically high.
- (8) In Figure 2 the CMA replicates the comparable Ofwat chart for wastewater in which the trend observed for water is completely absent.
- (9) For convenience, Figures 1 and 2 are replicated from the working paper below:

**Figure 1 Wholesale water base costs, comparison of the last year of expenditure to the average of the first four years of each AMP**



Source: Ofwat Response to Request for Information, Figure 1. Ofwat's reply to responses to the provisional findings – costs and outcomes, annex 6.

**Figure 2 Wholesale wastewater base costs, comparison of the last year of expenditure to the average of 2011/12-2014/15 and the first four years of AMP6**



Source: CMA, Figure 2, Water Redeterminations 2020 2019/20 data for base cost models – Working Paper

**2 Anglian disagrees it is likely that 2019/20 expenditure included a significant proportion of brought forward AMP7 expenditure**

- (10) In considering whether to update the base cost models with 2019/20 data the CMA sought to understand the reason for the atypically high level of expenditure in 2019/20 and concluded<sup>3</sup> that ‘a substantial amount of investment is likely to have been brought forward from AMP7 to 2019/20.’
- (11) Anglian disagrees with the CMA’s conclusion which rests almost entirely on the statements made by some companies in response to specific questioning by Ofwat. However, the evidence for this conclusion is very weak:
  - (i) the statements come from only six companies which make up less than half of the industry by revenue;
  - (ii) of these, only four companies, representing less than a third of the industry by revenue, quoted any figures;
  - (iii) the total sums quoted by these companies is only £168 million. This represents only 2.1% of total botex incurred by the industry in 2019/20;
  - (iv) the statements were solicited to try and explain the atypical expenditure in water. However, the companies state that the targets of their expenditure included waste water and overhead

<sup>3</sup> Para 51

services. Welsh Water said that most of its brought forward expenditure was incurred in sewer flooding;

- (v) United Utilities<sup>4</sup>, which quoted by far the biggest sum of 'brought forward' expenditure, stated that its investment was designed to improve performance *in AMP6* and AMP7. Hafren Dyfrdwy<sup>5</sup> said that its investments were to deliver *immediate benefits* as well as benefits into AMP7; and
  - (vi) Severn Trent<sup>6</sup> admitted that 'it is not straightforward to quantify which investment is specifically for 2020-25 targets'.
- (12) In other words, the statements on which the CMA rests its conclusion refer to comparatively small sums from a small proportion of the industry which have been directed at an unspecified mixture of AMP6 and AMP7 targets across an unspecified mixture of services. Collectively the evidence is therefore largely anecdotal and wholly imprecise. There is no basis for making any reasonably reliable estimate for how much expenditure – if any at all - may have been brought forward from AMP7 in either service. Insofar as there is any, the evidence provided suggests any such expenditure is immaterial.
- (13) The CMA acknowledges<sup>7</sup> the shortcomings in the evidence provided by companies but still concludes that 'a substantial amount of investment is likely to have been brought forward'. Anglian's conclusion is that, given the small proportion of the industry providing evidence on this fact and the imprecision of their responses, it is not safe to assume that any material sums of investment have been brought forward and the CMA has placed disproportionate weight on this evidence.
- (14) There is a further factor which the CMA does not appear to have considered in reaching its conclusion. In Anglian's response to the PFs<sup>8</sup> it observed that "post-delivery costs associated with AMP6 schemes form material proportions of expenditure in 2021/22 and 2022/23. 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. The CMA appears to have overlooked this important factor in its working paper, which further undermines the safety of its conclusion. Ignoring deferred expenditure from AMP6 while relying on weak evidence of brought forward expenditure from AMP7 leads to a very partial conclusion.
- (15) Anglian has analysed its AMP6 capital expenditure to understand the relative balance between expenditure deferred to a later price control period and that advanced to an earlier one. Its analysis showed that £18 million of the expenditure it reported for 2019/20 was coded to schemes from the AMP7 programme. However, it also found that £15 million of the expenditure it reported for the five years of AMP6 was coded to schemes from the AMP5 programme. This analysis shows that expenditure brought forward from AMP7 was offset by the expenditure deferred from the previous period, such that the net position of deferring and advancing expenditure between periods was nil.
- (16) Anglian cannot comment on the detail of companies' investment plans except for one: its own. The CMA refers to the £165 million which Anglian invested in 2018/19 and 2019/20<sup>9</sup>. Although this is cited as a further example of brought forward expenditure, Anglian can categorically state that this is not the case. This expenditure was not brought forward AMP7 money but a share of the outperformance it achieved in years 1-3 of AMP which the Board elected to reinvest for resilience and customer service enhancements.

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<sup>4</sup> Paragraph 10, bullet 1

<sup>5</sup> Paragraph 10, bullet 6

<sup>6</sup> Paragraph 10, bullet 5

<sup>7</sup> Para 46-47

<sup>8</sup> Anglian Response to Provisional Findings para 61

<sup>9</sup> Para 10

- (17) Anglian described this investment in its Annual Report Performance Report for 2018/19<sup>10</sup>:

*Our totex outperformance of c.£324 million is as a result of numerous totex efficiency measures and initiatives. Totex and Capital programme efficiencies continue to be driven through our Alliance delivery model, delivering efficient, innovative and lower carbon solutions. Our operating cost efficiency has been achieved through initiatives including supply chain efficiencies, lean process improvements, energy efficiency projects and general tight cost control. These continue to be key areas of focus as we move into the final year of the AMP.*

*By maximising the benefits of our alliances and innovation, and delivering strong efficiencies across our programme, we are able to deliver further benefits for customers. This commenced in 2017/18 and in total we are increasing our planned investment by £165.0 million over AMP6 to improve resilience and enhance our service to customers. During 2018/19 we re-invested £55.7 million in capital maintenance projects and £24.0 million in operational initiatives bringing the total reinvestment spend in the AMP to date to £79.2 million of capital maintenance and £26.8 million of opex.*

- (18) The source and timing of this investment is clear from this statement, which was made in July 2019 before even the publication of the PR19 Draft Determination. It is not tenable for this programme of expenditure to be presented as brought forward expenditure given that it commenced in 2017/18, the third year of AMP6, while the company was still only developing its AMP7 business plan.

### **3 Anglian compares the pattern of industry expenditure in AMP6 with previous AMP periods and proposes a more plausible explanation for 2019/20 expenditure.**

- (19) In the previous sections Anglian has acknowledged that expenditure in 2019/20 was atypical but rejected the CMA's conclusion for the cause, and its conclusion that this expenditure should not therefore be considered for the redeterminations. In this section Anglian explains the reasons for the atypical industry level of expenditure in 2019/20. The reason why water spend in 2019/20 was higher than any other year was not because of significant 'brought forward' AMP7 expenditure but to make good the underspends from earlier in the AMP. In other words, industry expenditure in the later years of AMP6 was unusually high because expenditure in the earlier years was unusually low. In the context of the redetermination task the CMA has before it, it is therefore essential that this expenditure be taken into account if AMP6 is to be accurately represented in the cost models. In the sections below Anglian presents evidence for this.

#### **3.1 The trends in spending**

- (20) The CMA considered the pattern of expenditure made by the industry over three AMP periods shown in figures 1 and 2. It concluded<sup>11</sup> that it was difficult to draw any conclusions from this analysis.
- (21) What Anglian observes from Figure 1 is that the pattern of water expenditure in AMP6 was significantly different from what occurred in the previous AMP periods. Instead of the relatively flat or somewhat dome-shaped curves observed in AMPs 4 and 5, there is a step-wise increase in expenditure across all years of AMP6.
- (22) Ofwat drew the charts to highlight the comparatively high levels of expenditure in 2019/20 but what is equally striking is the very low level of expenditure in 2015/16 and 2016/17 compared to comparable years in the previous AMP periods. Anglian has re-drawn Figures 1 and 2 below and extended them to the previous AMP period, 2000-2005. Rather than show the average expenditure across years 1-4,

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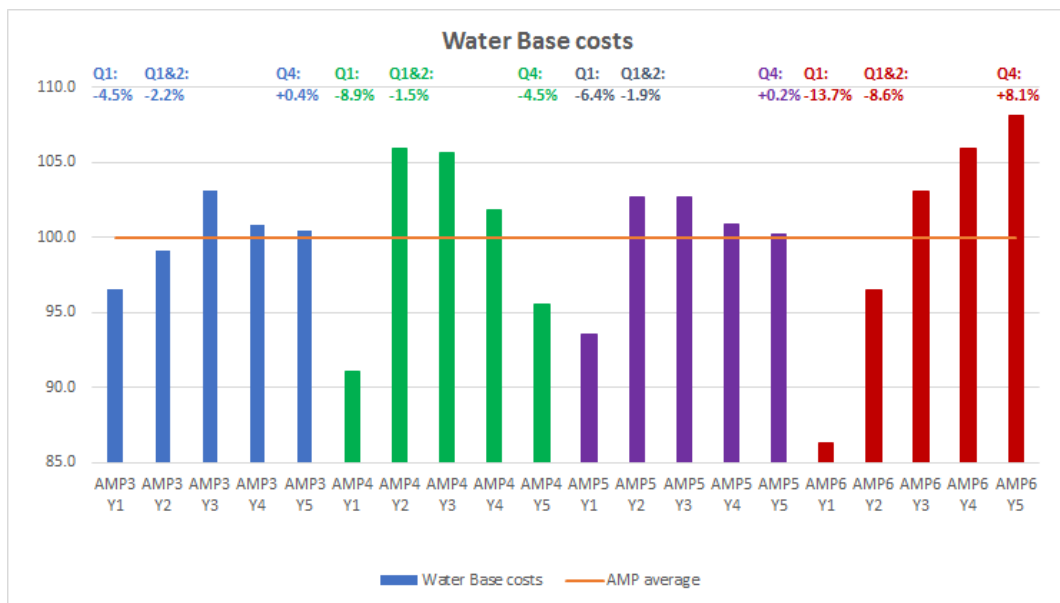
<sup>10</sup> Annual Performance Report 2019, page 106 paras 7 – 8. <https://www.anglianwater.co.uk/siteassets/household/about-us/annual-performance-report-2019.pdf>

<sup>11</sup> Para 39

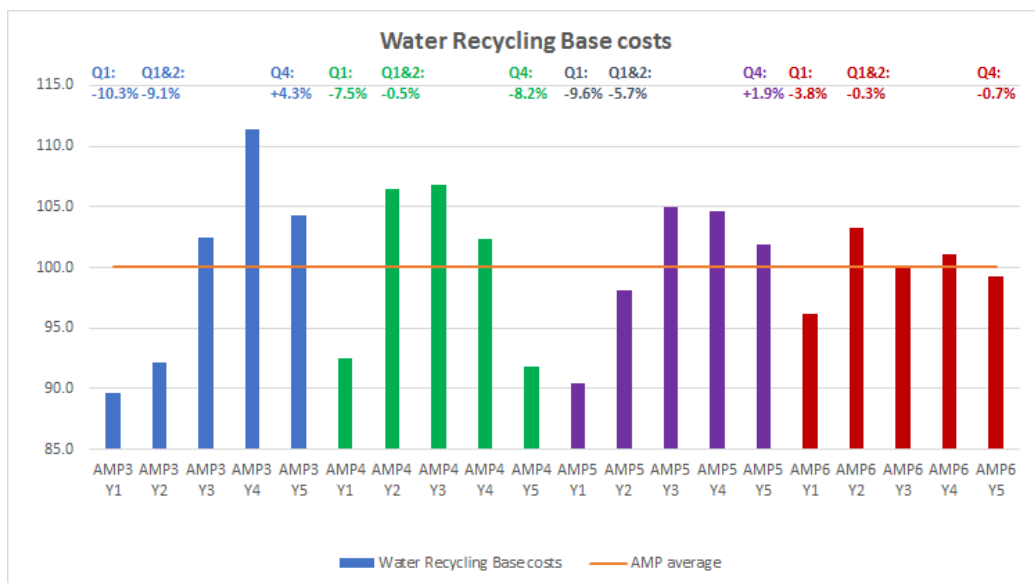
Anglian has compared expenditure in every year to the average for the whole period and indexed this to 100. **It is clear from this that in water the industry spent a significantly lower proportion of its total expenditure in the first two years of the AMP6 period than it did in the corresponding years of any of the previous periods.** Conversely, it spent a significantly higher proportion of its total expenditure in the final year. Anglian contends that the excess expenditure incurred in 2019/20 comprises overwhelmingly investment which was not made earlier in the period.

- (23) Anglian acknowledges that the average expenditure for the period would be higher if year 5 included a significant proportion of brought forward expenditure and that this would increase the variance between the expenditure in years 1 and 3 and the average. However, as shown in Figure 5, **overall the industry spent largely in line with its allowances in AMP6.**

**Figure 3 The distribution of total industry expenditure by year for AMPs 3-6 (water)**



**Figure 4 The distribution of total industry expenditure by year for AMPs 3-6 (waste water)**





- (24) The CMA has confirmed statistically the atypically low water expenditure in 2015/16<sup>12</sup>: 'the coefficient dummy variable for 2015/16 is negative and statistically significant.' However, rather than setting aside this evidence, Anglian contends that it supports its explanation of the pattern of spending in AMP6 and the high level of expenditure seen in 2019/20.

### 3.2 Companies' spending against their business plans

- (25) The CMA compared the industry's outturn spending in 2018/19 and 2019/20<sup>13</sup> with forecasts made in companies' PR14 business plans and observed that in both years and both services the industry spent more than it expected to.
- (26) Anglian's view is that comparisons between outturn expenditure and companies' business plans are of relatively little value. Once companies accept their final determinations the cost allowances contained within those determinations replace their business plans as expenditure benchmarks. Those allowances reflect the outcomes, outputs and efficiency assumptions baked into the determinations, replacing the corresponding assumptions included in business plans. Comparing companies' actual expenditure with their cost allowances is therefore more relevant and informative.
- (27) Having said that, the evidence supports Anglian's proposition that industry expenditure was deferred from the early to the later years of the period. Had the CMA extended its analysis from just years 4 and 5 to the whole of AMP6 it would have found that in years 1-3 the industry spent substantially less than it forecast to.

### 3.3 Companies' spending against their PR14 allowances

- (28) As set out above, Anglian suggests that, rather than comparing actual expenditure to business plans, a better comparison is between companies' actual expenditure and the cost allowances that were made at PR14. Once a company accepts its final determination its business plan forecasts become less relevant. A company is assessed and remunerated on how it performs against its allowances so this becomes the critical benchmark.
- (29) Ofwat provided a comparison between companies' actual and allowed expenditures in its Service Delivery report (December 2020). Anglian replicates the relevant figure from this report below. Ofwat's observations in this report describe the pattern of AMP6 expenditure very well: 'Generally, expenditure across the sector during 2015-20 follows a similar pattern for most companies. The first two years of the price control saw significant underspend: expenditure in 2015/16 and 2016/17 was around 6% lower than allowances. Expenditure then increased year-on-year, out-turning in 2019/20 at 12% higher than allowances.' The industry's total expenditure over the full five years was 1% higher than its PR14 allowances.<sup>14</sup>
- (30) Once again, **this evidence supports Anglian's proposition that industry expenditure was deferred from the early to the later years of the period, within the broad envelope of the PR14 allowances.**

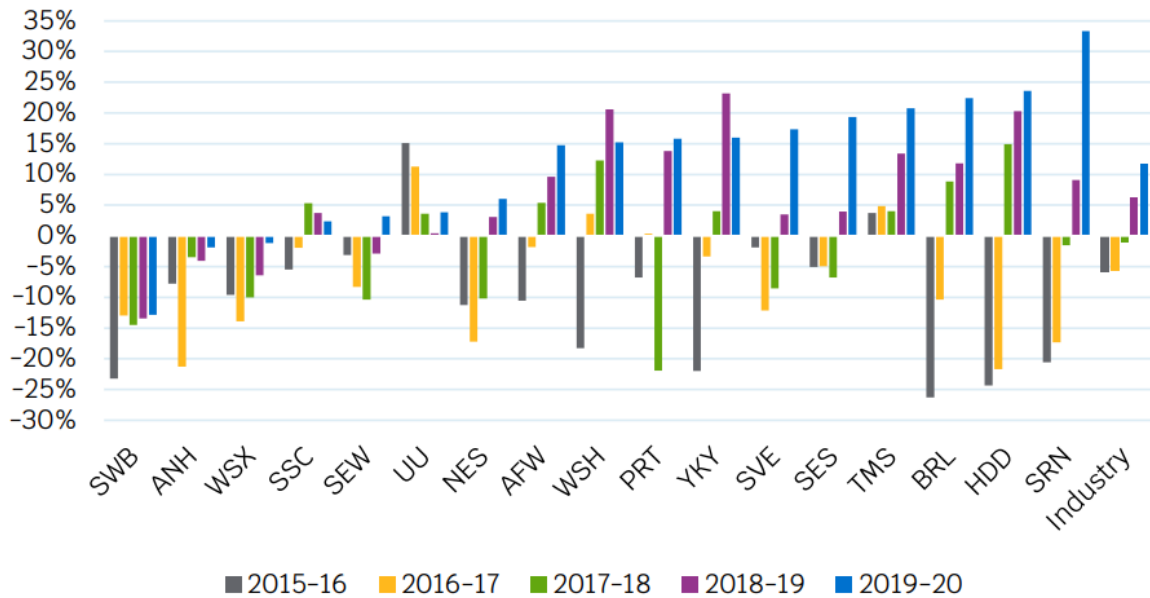
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<sup>12</sup> Para 36

<sup>13</sup> Paras 40-44

<sup>14</sup> Anglian recognises that this analysis is prepared on a totex basis while the working paper refers to base cost modelling. Anglian has previously explained that Ofwat's cost allowances at PR14 were made on a totex basis and it is not able to estimate the split between base and enhancement for other companies. However, Anglian also refers to analysis in its Reply to Ofwat's response (Part G, pages 4-11) in which it showed that it has essentially spent all of its allowed botex over the last 20 years. Anglian believes that the factors which mitigate against botex outperformance, which it described in that document (page 8), apply to all companies.

**Figure 5 Annual outperformance as a % of annual allowed wholesale totex**



Source: Ofwat Service Delivery Report 2019/20 page 8<sup>15</sup>

**4 Not only does the pattern of expenditure in AMP6 differ from previous AMP periods there is a credible explanation for that difference rooted in the regulatory framework of AMP6**

- (31) In its follow-up to the December hearings Anglian not only described the pattern of AMP6 expenditure but also explained the reasons for it. These included that:
  - (i) Companies' expenditure in 2015/16 was very low as companies assessed the impacts of the new totex and outcomes regime, and
  - (ii) The number and / or stringency of performance targets increased as the AMP progressed.
- (32) While **the working paper acknowledges these points<sup>16</sup> it does not report the CMA's assessment of them. However, Anglian contends that its proposition that 2019/20 expenditure was atypically high because it included deferred expenditure from earlier in the AMP period is strongly supported by the fact that regulatory mechanisms in AMP6 were very different from previous AMP periods and that companies' behaviour changed markedly as a rational response to this.** Combining the observed pattern of expenditure with the known facts about the regulatory incentives and the credibility of the behavioural response to those incentives leads to a compelling proposition to explain 2019/20 expenditure. In this section Anglian therefore provides a fuller explanation of the reasons it set out in its response to the December hearings<sup>17</sup>.
- (33) A key objective for Ofwat of the PR14 price review was to provide companies with greater flexibility and freedom to deliver outcomes for their customers. Ofwat's analysis of the industry after PR09 was that companies were unduly focussed on the regulatory regime. It said they were driven by their regulatory settlements - to deliver the outputs, which were typically defined in a very specific manner, within their cost allowances. Ofwat observed that this focus on outputs prevented companies from considering

<sup>15</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2020/12/Service-delivery-2020-final-1-Dec.pdf>

<sup>16</sup> Para 18

<sup>17</sup> Submission following November and December main party hearings 17 December 2020, Annex 2 Chapter C Botex part 2

whether customers' needs could be met in a more efficient or effective manner and contributed to low levels of innovation in the industry. Ofwat concluded that for AMP6 companies should be incentivised to understand more clearly the outcomes that their customers wanted and allowed greater freedom to deliver those outcomes.

- (34) Some quotes from Ofwat's final methodology document for PR14 illustrate these significant changes in its approach<sup>18</sup>:
- (i) 'Under our approach companies will take full responsibility for planning their business and listening to their customers, and not simply tick regulatory boxes'<sup>19</sup>.
  - (ii) 'It is now up to companies to use the flexibility and tools we have given them to respond to the challenges from their customers, environmental stakeholders and policy makers'<sup>20</sup>.
  - (iii) 'Some of our changes remove aspects of regulation that were too prescriptive, or had the potential to distort companies' decision making – for example, our move to assessing costs on a total expenditure ('totex') basis removes any undesirable incentives for companies to seek capital expenditure-intensive solutions where there may be better alternatives.'
  - (iv) 'Boards of companies should focus on what their customers want rather than what the regulator wants'<sup>21</sup>.
  - (v) 'We are also changing the way we assess wholesale costs to drive value for money for customers, efficiency, and ensure companies are free to make the right investment decisions. Our move to totex should allow companies to decide on the right investment solution to drive benefits for their consumers, rather than one that is influenced by the way the regulator looks at costs'<sup>22</sup>.
- (35) One way in which these principles were put in practice on expenditure was that companies were given total expenditure ('totex') allowances rather than separate allowances for base opex, capital maintenance, capital enhancement and enhancement opex. Companies were given the freedom to spend in the most efficient and effective way within these totex allowances without the boundaries and incentives that might have distorted their spending decisions previously.
- (36) Crucial to the topic of this paper is that there was also a relaxation around the timing of expenditure. In previous price control periods regulatory mechanisms took into account the year in which expenditure was made in comparison to assumed expenditure for that year. This may well have been an aspect of regulatory process with the potential to distort companies' decision making which Ofwat referred to in its PR14 framework paper.
- (37) By comparison, under the PR14 cost performance methodology annual comparisons were scrapped; companies were assessed solely on the comparison between their expenditure and their allowances over the full five years of the period. In the absence of regulatory distortions, companies were free to phase their spending in accordance with drivers other than the regulator's assumed expenditure profile.
- (38) Some of those drivers remained the same in AMP6 as in previous AMP periods. For example, companies' quality enhancement programmes were still framed around the deadlines to meet statutory obligations. However, a key new set of drivers for every company was its suite of performance

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<sup>18</sup> Setting price controls for 2015-20 – final methodology and expectations for companies' business plans, Ofwat, July 2013  
<https://www.ofwat.gov.uk/publications/setting-price-controls-for-2015-20-final-methodology-and-expectations-for-companies-business-plans/>

<sup>19</sup> Page 3

<sup>20</sup> Page 3

<sup>21</sup> Page 5

<sup>22</sup> Page 6

commitments. Until AMP6 the only PC was the Service Incentive Mechanism (SIM). On base, companies' incentives were to optimise their performance under SIM, maintain the serviceability of their assets and perform satisfactorily against a handful of high profile measures which might otherwise attract reputational damage, such as leakage and customer complaints.

- (39) The PCs introduced at PR14 created a wholly new and different set of drivers. In addition to reputational incentives, companies now had the capacity of earn material financial rewards and attract material financial penalties according to their performance against performance commitment levels (PCLs).
- (40) Crucial again to the topic of this paper is the phasing of the incentives under the PC regime. PCLs were not set for every year and the level of the PCLs generally became more onerous as the price control period continue. The table below is from Anglian's response to the December hearings as a reminder that it had twice as many PCLs in year 5 as in any other year. Anglian's response to the hearings also highlighted that of Anglian's 15 performance commitments which had PCLs in every year of AMP6, five had PCLs which became more onerous as the period progressed<sup>23</sup>.

**Table 1 Anglian Water's PCLs in each year of AMP6<sup>24</sup>**

		2015/16	2016/17	2017/18	2018/19	2019/20
Number of PCLs		15	15	16	15	32

- (41) **The changes to the regulatory framework described above are entirely consistent with the pattern of industry expenditure observed across AMP6.** Furthermore, the nature of the changes explains why the pattern differed from previous price control periods. From the start of AMP6 companies were faced with a new suite of material incentives that become more powerful as the period progressed, Regulatory arrangements that had previously influenced the timing of their expenditure had been removed, leaving the companies with the freedom to match their expenditure to the challenges they faced.
- (42) **The advantages of updating the models significantly outweigh the disadvantages and bias will be introduced if the models are not updated for the final re-determination.**
- (43) Anglian agrees with the CMA's analysis<sup>25</sup> of the potential advantages and disadvantages of updating the base cost models with 2019/20 data. Having rejected the CMA's conclusion about the likelihood of 2019/20 data including substantial amounts of brought forward AMP7 expenditure, Anglian disagrees that there would be a material disadvantage from updating the models with data from this year. On the contrary, Anglian believes the advantages from doing so substantially outweigh the disadvantages.
- (44) Going further, Anglian believes that bias will be introduced into the forecasts produced by cost models that are not updated for 2019/20 data because 2019/20 was the year in which the greatest proportion of AMP6 expenditure was made. By only using data from years 1-4 of AMP6, the total expenditure of AMP6 has been significantly understated and will create a disconnect between the service delivered to customers and the costs of doing so. Furthermore, by excluding 2019/20 data, the CMA is placing greater weight on the early years of expenditure in the data panel (e.g. 2012/13 - 2014/15) which pre-date AMP6. The nature of expenditure in these years has not been scrutinised in any detail and yet it is proposed that they are more representative than the most recent year of industry expenditure to inform future allowances.

<sup>23</sup> Para 32, Anglian Submission following November and December main party hearings dated 17 December 2020

<sup>24</sup> Table 3, Anglian annex 2 Submission following November and December main party hearings 17 December 2020

<sup>25</sup> Paras 28-32

#### **4.1 Updating of cost driver forecasts**

- (45) The CMA proposes<sup>26</sup> to incorporate 2019/20 outturn data for the cost drivers of its models and update its cost drivers' forecasts for 2020/21-2024/25 accordingly.
- (46) Anglian supports the principle that decisions should always be based on the most recent information, unless there is compelling evidence for believing that that information might lead to biased conclusions. In the same way that Anglian sees no compelling evidence for ignoring the data from 2019/20 on costs, Anglian sees no compelling evidence for ignoring the data from 2019/20 on cost drivers and supports the CMA's proposal to update cost driver forecasts accordingly.

#### **4.2 Methodological issues**

- (47) The CMA proposes<sup>27</sup> that frontier shift should be applied to forecast data, not outturn data. Its provisional view is that, if it were to incorporate 2019/20 cost data, frontier shift should be applied from 2020/21.
- (48) Anglian supports this. If frontier shift were to be applied from 2019/20 it would be in addition to the frontier shift improvements which had already been achieved and reflected in that expenditure. This would be a clear abuse of an established and accepted regulatory mechanism for recognising future frontier shift improvements in cost allowances.
- (49) On the treatment of the Severn Trent – Dee Valley merger / de-merger, the CMA proposes<sup>28</sup> that if it were to incorporate 2019/20 cost data, it would: -
- (i) In wholesale water, drop HDD, and include SVE as a separate entity for 2019/20
  - (ii) In wholesale wastewater, treat SVE and HDD as a single entity rather than a separate entity.
- (50) The wording in the working paper on this topic is brief. Furthermore, because the CMA has not performed the updated modelling and published its detailed analysis, it is not possible for Anglian to be entirely clear about the approach which the CMA proposes. Anglian understands that the proposed approach is the same as that which Oxera took in its analysis after carefully identifying and weighing up the pros and cons of other approaches,<sup>29</sup> and on that basis Anglian supports the CMA's proposal. However, for the avoidance of doubt, Anglian regards the correct way to treat the issues raised by the Severn Trent / Dee Valley merger / de-merger to be the one adopted by Oxera.
- (51) The CMA proposes<sup>30</sup> that it should not change the efficiency challenge solely due to any change in allowances. Rather than seek specific outcomes, instead it should set the efficiency based on its assessment of the quality of the econometric modelling.
- (52) Anglian has consistently said that the efficiency challenge should be proportional to the quality of the underlying models and not a goal-seeking tool. Anglian therefore supports the CMA's proposed approach.
- (53) Anglian proposes an additional methodological feature to mitigate against the risk of updating the base cost models with 2019/20 data. If, after the reviewing the evidence provided by Anglian, the CMA remains concerned about the introduction of bias from including the most recent data, it could cap any company's allowance at the lower of the allowance resulting from the updated models and the

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<sup>26</sup> para 66

<sup>27</sup> Para 67

<sup>28</sup> Para 67

<sup>29</sup> Pages 3-4, *On the use of 2019/20 APR data in econometric modelling*, Oxera, October 2020

<sup>30</sup> Para 67

expenditure that company sought in its business plan. This rule would ensure that no company received a higher base allowance than its own assessment of its expenditure needs.

## 5 Conclusion

- (54) The CMA<sup>31</sup> states that it is common practice for the CMA to exclude data that it finds to be unreliable or unrepresentative. Having concluded it is likely that 2019/20 expenditure includes a significant proportion of brought forward expenditure AMP7, the CMA therefore decides that the expenditure data for 2019/20 are unrepresentative for the purposes of forecasting future expenditure allowances and that their use would introduce bias into those forecasts.
- (55) Anglian has identified weaknesses in the evidence for the CMA's conclusion and that undue weight has been placed upon it. Anglian has shown that the decision to ignore the 2019/20 data for modelling and forego the benefit of using this more recent data is therefore disproportionate. It has explained that the primary reason that expenditure in 2019/20 was atypically high is because expenditure in the early years of AMP6 was atypically low. Anglian has demonstrated that the pattern of expenditure in AMP6 was markedly different from previous price control periods and explained the fundamental changes in regulatory methodology that have caused this.
- (56) **Anglian's analysis demonstrates that bias will be introduced into the forecasts produced by cost models that are not updated for 2019/20 data, because 2019/20 was the year in which the greatest proportion of AMP6 expenditure was made.** By only using data from years 1-4 of AMP6 the total expenditure of AMP6 has been significantly understated. Whereas the impact of omitting year 5 expenditure data from models used at previous price reviews was low, the changed pattern of expenditure in AMP6 makes the impact significantly more material.

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<sup>31</sup> Paragraph 61