

**Anglian Water**

**PR19 CMA Redetermination**

**Annex 1 Costs, Outcomes and Regulatory Precedents Annex**

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## **Annex 1: Costs, Outcomes and Regulatory Precedents**

### **1 Anglian Water: Final Submission to the CMA**

#### **2 Introduction**

- (1) Anglian has already provided to the CMA its substantive responses to the consultations and RFIs issued earlier this year. This final submission comprises two annexes to Peter Simpson's letter to Kip Meek. They aim to draw out the key points that Anglian believes are important for the CMA to address in its Redetermination, including those that are critical in relation to future regulatory approaches.
- (2) In addition, this submission sweeps up a small number of issues that remained outstanding from those previous responses, and offers some brief rebuttals to the points made in Ofwat's final response to the WACC working papers, and its RFI033 response on leakage.

#### **3 Risk and Return**

- (3) In its PFs, the CMA correctly identified that the FD had created a significant asymmetry between risk and return, and that the notional company was not financeable at the cost of capital Ofwat proposed. Critically, the PFs recognised the umbilical cord between the overall balance of risk and return, the WACC, and incentives for future investment to deliver resilience objectives. The cross-check on notional company financeability, on the same basis as set out in the PFs, will be a critical element to steer the CMA's final decisions.

#### **4 Customer interest at the heart of our business**

- (4) Anglian firmly rejects Ofwat's assertion that it is the only body that is acting in the interests of customers.
- (5) This is a gross mischaracterisation and ignores the fact that the Board of Anglian Water took great care to ensure it was responding to the express wishes of customers in its Business Plan. Moreover, it ignores the significant efforts, of the thousands of hard-working Anglian employees who have put themselves on the front line, day in and day out, throughout the pandemic, through crisis events like Beast from the East, and the recent flooding, doing all they can to help the customers they serve.
- (6) The interests of customers and the environment, in the short and the long term, are at the heart of how Anglian Water takes decisions. This is embedded in Anglian's Articles of Association and its stated Purpose. Decisions taken each day are informed by the views of customers gathered through ongoing engagement, rather than this being an exercise undertaken for the purposes of a price review. It is these customer interests that drive the Anglian position on the remaining points of difference in the redetermination, especially in relation to safeguarding security of water supply and underpinning necessary investment.

#### **5 Views of third parties**

- (7) As is evident from the sheer volume of third-party submissions to the CMA, throughout the redetermination a large number of interested third parties have been keen to give their views on the critical issues being tested. This includes supply chain companies, charities and companies in the water sector and in other regulated industries.
- (8) In particular, a large number of third-party submissions highlighted that resilience and environmental protection should be priorities for the CMA. Organisations ranging from the CBI to the RSPB, the East of England LGA to Water Resources East have highlighted the importance of securing long-term resilience, and the risks created by the FD.

- (9) Of the third-party submissions responding to the cost of capital consultation, the vast majority supported the PFs position. Universities Superannuation Scheme Investment Management highlighted that it has not invested in the water industry since 2017 “*in large part because of the direction of travel in regulation in the sector, which we assessed resulted in materially increased risks combined with an outlook of insufficient returns on capital*”<sup>1</sup> underlining the importance of ensuring the redetermination supports continued investment into the sector. Responses to the Leakage Working Paper consultation highlighted the inappropriateness of a one size approach and that marginal costs increase as leakage levels fall.<sup>2</sup> The majority of third-party responses to the 2019/20 data consultation were supportive of its inclusion<sup>3</sup>. Likewise, the parties responding to the Elsham consultation were both supportive of Anglian’s position, recognising the risk of delay if the wider scope of the scheme remains under DPC.

## **6 Security of Water Supply**

- (10) As Peter’s letter to Kip explains, the risk to security of water supply in the East of England is already acute, and has risen during the redetermination process. This is driven by a combination of:
- (i) the growing threats posed by climate change and extreme weather events;
  - (ii) the pressures of population and housing growth;
  - (iii) the step change reduction in available water that results from the Environment Agency’s programme to reduce the amount of water companies can abstract; and
  - (iv) the unprecedented increase in per capita consumption of water that is the result of behavioural changes in response to Covid-19, with far less travel out of the region than before the pandemic, and which is expected to continue to be reflected (albeit in a less extreme way) once lockdown restrictions begin to ease.
- (11) As Anglian has demonstrated to the CMA through the “jaws of death” chart<sup>4</sup> included in its submissions and discussed at its hearings, without urgent action the region will hit the point where its supply-demand situation is no longer in balance by the end of this AMP.
- (12) The only tools available to Anglian to mitigate this risk in AMP7 are around demand management, particularly leakage, and smart metering. Anglian does not repeat here all the arguments it has already presented to the CMA on these matters. Yet it is clearly critical that base cost allowances are sufficient to allow Anglian first to maintain its frontier position on leakage, which can be addressed through accepting Anglian’s leakage Cost Adjustment Claim, and then to push beyond that to deliver even lower levels of leakage through appropriate enhancement allowances.
- (13) On smart metering, Anglian has asked the CMA to recognise the importance of delivering its smart metering programme given the security of water supply challenges. The proposal Anglian has put to the CMA would allow for the timely replacement of assets, whilst also protecting customers from the risk of facing repeat recovery costs in future periods, as set out in the smart metering Cost Adjustment Claim.

## **7 Direct Procurement: the Elsham Schemes**

- (14) Anglian was grateful to the CMA for consulting specifically on the scope of the Elsham schemes, given the risks that the wider scope proposed by Ofwat presents in terms of both meeting our legal obligations by 2025, and ending up with a “dry grid”. As Anglian has explained, there is currently a real risk that the

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<sup>1</sup> See also, third party representation from OPTrust on withdrawal of investment from Thames Water.

<sup>2</sup> See for example WaterUK

<sup>3</sup> See for example iCON infrastructure LLP

<sup>4</sup> See Anglian’s SOC, figure 20 and Anglian’s response to the Elsham Consultation 11 January 2021, figure 1.

wider SPA project could deliver all of its specified outputs, but the desired resilience outcomes might not be met if the water at the top of the grid, dependent on the Elsham transfer scheme, is delayed by the DPC process.

- (15) Anglian believes that its response (and that of third parties) to the Elsham consultation provides the evidence for the CMA to make a decision in favour of descope. However, if it is unsure of the best course of action, the CMA should check whether Ofwat has now agreed with the proposal to descope, before it makes its final decision on DPC scope.
- (16) Anglian has continued to discuss these issues with Ofwat, and hopes that the arguments for a descope DPC scheme may yet be accepted by Ofwat. Should this be the case, the public interest would be better served by the implementation of that reduced scope through the redetermination, rather than through the more time-consuming IDOK process that Ofwat would have to operate, not least as the biggest risk is to the timetable of the scheme, which could be averted should the CMA include this decision in its redetermination.

## **8 Leakage**

- (17) Anglian welcomed the commitment from the CMA in its PFs to conduct further analysis of companies' leakage costs. Throughout the CMA process, including in response to the CMA's leakage working paper and RFI033, Anglian has explained the basis of its Cost Adjustment Claim, which is needed as Ofwat's base modelling framework does not appropriately capture the higher *recurring* base expenditure required to maintain a frontier level of leakage performance as achieved in AMP6, given the labour-intensive nature of leakage control.
- (18) By contrast, Ofwat's RFI033 response continues to suggest, incorrectly, that AMP6 base costs are one-off whilst also suggesting, again incorrectly, that its econometric models fund forecast AMP7 UQ levels of leakage. Ofwat's assertion in its RFI response that Anglian has not responded to a series of points in relation to leakage base costs is also wholly unfounded. This is evidenced by the significant body of evidence Anglian has provided throughout the process, which is fully referenced in its response to the leakage working paper.
- (19) Anglian, supported by third-party company submissions, has also evidenced why the CMA is right to recognise that there are increasing marginal costs of leakage improvements.

## **9 Use of 2019/20 Data**

- (20) Anglian's detailed response to this consultation, as well as those of other disputing companies, is already before the CMA. Anglian asks that the CMA gives full consideration to the arguments all appellants have made on this matter, and to uphold the regulatory principle that the most up to date information should be used unless there is some material, evidence-based, overriding reason not to. Anglian's evidence has demonstrated this is not the case in relation to this final year of AMP6. Nothing in Ofwat's response to RFI033 contradicts the central point of all disputing companies' responses to the working paper, that the purported evidence of the inclusion of material sums of 'brought forward' AMP7 expenditure in 2019-20 data falls far short of the standards required to deviate from this regulatory principle.

## **10 Cost modelling issues: Average Pumping Head and Water Recycling Centres**

- (21) Anglian has already presented detailed evidence to the CMA on these matters. In this final submission Anglian wishes to reiterate its view that Ofwat's cost models fail to account for the impact of topography on companies' costs, through their reliance on inappropriate and unreliable pumping station variables. Anglian faces substantial unavoidable costs in relation to pumping costs, linked to its topography, that

have traditionally been captured through Average Pumping Head in cost models and which Ofwat's models fail to capture. This should be remedied in the redetermination.

- (22) For the costs of Water Recycling Centres, the region Anglian serves has no very large urban centres, and so operates a large network of very small WRCs. This drives higher costs than for companies with larger WRCs, and these costs are not recognised in Ofwat's models. Again, these are legitimate and unavoidable costs that Anglian faces, that should be recognised in the CMA's redetermination.

## **11 Longer term regulatory precedents of the CMA's redeterminations**

- (23) A point of discussion in Anglian's hearings has been the extent to which it is right for the CMA to give its view on longer term regulatory principles as part of its redeterminations. Alex Plant's answer to that question was that it was entirely legitimate and desirable for the CMA to do this, and this remains Anglian's view, not least given the sheer scale of challenges facing the sector, including but not limited to the delivery of net-zero carbon by 2030.
- (24) The opportunity that the redeterminations have afforded for the CMA to consider these issues is very valuable, and Anglian urges the CMA to offer its opinion on how regulation can improve for PR24 and beyond to ensure these challenges can be met.
- (25) Thinking about this more specifically in relation to the topics that have garnered significant attention from the CMA, Anglian asks that the CMA sets out its views on the longer-term regulatory approach that should be taken in relation to:
- (i) Leakage: including the full recognition that marginal costs increase for companies operating at the frontier (and the corresponding impact on cost allowances that this entails), and that the regulatory system should create positive incentives for companies to strive to be at that frontier and pushing it forward rather than incentivising mediocrity. The CMA should also recommend that a more rigorous approach to evidence of leakage expenditure, on a consistent basis across companies, be put in place in time for PR24 to allow for better regulatory determinations on leakage to be made.
  - (ii) Growth: Ofwat has struggled over the last two price reviews to come up with a robust approach to dealing with the uncertainties of growth. A recommendation for this being prioritised for PR24 would be helpful, not least in the context of the Government's aims to accelerate a housing-led green recovery, and the specific challenges for a number of companies to accommodate the ambitions of the Oxford-Cambridge Arc. The CMA could also consider offering advice to Government on the desirability of having a single set of growth forecasts that should be used for central government purposes, local authority plan-making, and for sector regulators.
  - (iii) Capital maintenance: As the report from Dr Harry Bush and John Earwaker pointed out, Ofwat had undertaken no bottom-up, forward-look assessment of capital maintenance needs. Anglian welcomes Ofwat's project that is now underway to look at the longer-term requirements for asset health and resilience, and the CMA's views would be a valuable input to that process.
  - (iv) Customer engagement: In both PR14 and PR19 companies, customers, challenge groups and stakeholders have put huge effort into understanding customer views and ensuring that company plans accurately reflected these. And yet in two consecutive price reviews Ofwat has largely ignored this valuable evidence, in favour of a one-size-fits-all approach, and there is a risk that this could undermine the role of customer engagement in PR24 if the problems are not addressed. Views from the CMA on the weight that should be placed on high quality customer engagement would be very helpful. This could reflect on the third-party input it received from Professor Stephen Littlechild on this matter, and the approach that WICS has pioneered in Scotland which seems to have enabled a far more collaborative and consensual approach to

emerge between company, customers, stakeholders, regulators and Government, and has created a long-term path to meeting net-zero carbon goals.

- (v) Longer-term resilience investment: The CMA has recognised the need for an overall long-term strategic view to ensure resilience. For example, by specifically reversing Ofwat's interventions on Anglian's WRMP, the CMA recognised both the need for and cost efficiency of Anglian's proposed strategic interconnector programme. Given that the statutory WRMP process already robustly tests whether investments are needed, Ofwat should focus on whether the costs proposed to meet that need are efficient through its price review process, rather than again challenging need. This point is affirmed in the government's Strategic Policy Statement.<sup>5</sup>
- (vi) Effective and consistent regulatory incentives: As pointed out during the redetermination, the current suite of regulatory incentives and the price review process incentivises short-term low-cost business plans driven to align with the regulator's preference for lowest possible bills over 5 years, rather than incentivising the right level of investment over multiple regulatory periods, which minimises the cost to customers over the long term whilst delivering resilient outcomes. Specific examples include the design of "fast tracking" in the business planning process and the role of asymmetric cost sharing rates.

## 12 Conduct of parties throughout the Redetermination process

- (26) Anglian has conducted itself professionally and cooperatively throughout the process, as of course has the CMA itself: Anglian's interactions with staff and Panel at the CMA have been constructive on both sides. Anglian believes this is important to reaching well-reasoned conclusions within a redetermination, and to the perceptions of the validity of the process to participants and outsiders.
- (27) It is therefore both surprising and very disappointing that Ofwat has chosen to adopt such a disrespectful and rude tone, combined with aggressive criticism and numerous repeated mischaracterisations in its submissions (including but not limited to the incorrect description of Anglian's dividend levels) despite clear counter evidence being presented. This has been evident both in its behaviour towards the CMA and towards the disputing companies. It is also regrettable that Ofwat has sought during this process to make specific leading comments in the media<sup>6</sup> rather than directing its full efforts in a measured, appropriate way into the CMA's redetermination process itself.
- (28) Moreover, by approaching the redetermination as if it were a litigation, and adopting an adversarial and litigious approach throughout, Ofwat has undermined the proper advisory role it is supposed to play in a redetermination. Ofwat's role is to act as an expert advisor, helping the CMA as the decision-maker to arrive at its view in executing its statutory duties. It has not done this, but has chosen instead to defend its PR19 methodology and outcome position at all costs, even in the face of clear evidence to the contrary. It has attacked any organisation that may offer a different view, whether that be the CMA, the disputing companies, third parties, or the independent Customer Challenge Groups that tested the quality of companies' customer engagement, even going as far as to suggest that they were not acting independently.
- (29) Such behaviour does not sit well with a public body that should be holding itself to the highest standards. It has undermined trust and confidence in the regulatory regime as a whole. Very specifically, it has

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<sup>5</sup> See Para 13 of the SPS (SOC257): "*We expect Ofwat to recognise the need for investment in solutions to balance supply and demand and achieve the level of service that is set out in final water resources management plans. We also expect Ofwat to continue to challenge companies to meet that need in a way that represents the best value for money over the long term, including through the price review. Ofwat should work closely with the Environment Agency and use its role as a statutory consultee on water resources management plans to enable it to recognise future investment needs, in line with its statutory duties.*"

<sup>6</sup> For example 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).

undermined confidence in the redetermination process itself, which potential investors in the sector have previously seen as a critical part of the overall framework in assessing whether to invest. Rebuilding this confidence, and maintaining the principles of better regulation, is hugely important to the attractiveness of the UK as a destination for investment capital, and for keeping down the related costs of attracting such capital. The CMA has the opportunity to make some statements on these matters in its redetermination, and Anglian strongly urges it to do so.