Water 2020: Regulatory framework for wholesale markets and the 2019 price review

Consultation response from Anglian Water – February 2016

Contents

Main consultation response

Executive Summary

Anglian Water broadly welcomes the reform proposals set out by Ofwat in its Water 2020 consultation. We believe that market reform should be taken forward where:

- analysis of parts of the supply chain suggests there are potentially contestable markets;
- the development of such markets is likely to bring long-term benefits for customers and the environment and preserve the right conditions for investment and;
- the use of markets can help to strengthen the resilience of water and waste water systems to the challenges of climate change and population growth.

We believe that Ofwat's current proposals to open new upstream markets in sludge and water resources meet these criteria. We are also supportive of the proposals to strengthen the customer engagement process for the 2019 Price Review (PR19). However, we would urge Ofwat to put customer engagement at the heart of the PR19 process, and place more weight on the outcomes of good customer engagement processes in its consideration of business plans.

Ofwat has taken an open and consultative approach in developing the proposals set out in its December 2015 consultation. The engagement with the sector and interested parties through the Market Place for Ideas has helped to create a well-informed, strongly-evidenced and carefully considered set of documents. We feel that, if Ofwat can respond positively to some specific points we set out in detail below, the Water 2020 programme should then help to enhance trust and confidence in water. It should also deliver the right balance between promoting markets, safeguarding investment, and maintaining effective regulation of the network elements of the sector.

1. **On the move from RPI to CPI**, the primary concern should be to ensure that the transition is achieved at the lowest possible cost for customers and companies, rather than seeking to deliver the transition quickly. Our detailed paper on this proposes an alternative approach which would achieve this aim.
2. **For water resources,** the key issue is to ensure resilience of future supplies. Trading is welcome where it is possible but will be limited by requirements on "no deterioration", the proposed removal of headroom from existing abstraction licences, and the need to restore sustainable abstractions.
3. **For large projects**, the current portfolio approach that water companies have taken to capital investment, where risks are offset across the programme rather than being carried on each project, has seen significant benefits retained for customers. This should be borne in mind when considering options for external procurement of large projects.
4. **On sludge**, to support the development of this market, we have promoted the adoption of the Biosolids Assurance Scheme (BAS) to deliver a consistent approach across the sector and ensure a level playing field as markets develop. We believe the boundary for the contestable market should be at the sludge treatment centre gate. This would facilitate entry by new treatment providers, whilst avoiding any increase in sewage works compliance risk for incumbents. We do not think it is clear that a separate price control is needed to allow a market to develop.

Our specific comments below focus on areas of the consultation where we believe further work would help to improve the Water 2020 proposals. They are:

a) Access Pricing

b) Sludge

c) Water Resources

d) Large Schemes

e) Cost Assessment

f) RPI/CPI Indexation

g) Customer Engagement

A. Access pricing

Overview

The consultation document rightly sets out the two core principles required by an effective access pricing regime, facilitating efficient entry whilst ensuring that historic efficiently-incurred costs are suitably recovered.

Access pricing regimes have complex relationships with other parts of the regulatory framework, specifically the further disaggregation of wholesale price controls, cost allocation, information capture and suitable treatment of the RCV. The right blend of each of these aspects is required to ensure that potential markets send the correct efficient pricing signals.

RCV Allocation

Several of the contributions to the Market Place for Ideas, including our contribution, noted that RCV allocation is not a necessary prerequisite for developing access prices. This possibility is acknowledged within the consultation. However, we have suggested that a full exploration of all the possibilities should be undertaken before final decisions are taken. This would create the best chance of designing an optimal access pricing regime, but will require a little more time.

Water Resource Zones

We agree that the starting point for setting access prices should be at the Water Resource Zone (WRZ) level. This is appropriate given the nature of the WRZs and that they are the building blocks for companies in their Water Resource Management Plans. Companies also publish combined access prices within existing Network Access Codes.

Need for further analysis

We are pleased that Ofwat has acknowledged that further thinking is required on access pricing, noting the complexity of the issues. We will work with Ofwat and other contributors to the Market Place for Ideas on this issue. This will necessarily take place beyond the current consultation window, including through a dedicated workshop that is being scheduled at the time of writing.

B. Sludge

Overview

As flagged above, we are supportive of the principle of opening up the sludge market, but recognise there are barriers to achieving effective sludge trading that may not be readily solved.

Ofwat's analysis of the organic waste market and the opportunities it potentially provides to sewerage companies for increased efficiency in their sludge treatment operations is sound. In recent years we have explored a number of opportunities within our own operations, including:

- Treating sludges from other sewerage companies;
- Treating other organic wastes;
- Paying for other sewerage companies to treat our sludge, and;
- Paying for other treatment providers to treat our sludge.

One of the barriers we have encountered is the availability of information necessary to identify viable trades. Ofwat's proposals on publishing information will assist in this regard.

However, we note there are also a number of other barriers to the operation of an effective market that may be less easy to remove. These include:

- Environmental regulations that reduce the recycling options available once sludge is co-digested with other organic wastes;
- The high cost of transporting sludge relative to its inherent value;
- The risk of 'indigestion'[1] when mixed wastes are co-treated, and;
- Concerns about an over-dependence on other treatment providers and the loss of resilience that would arise from sudden loss of their service.

Changes to the economic regulatory regime may facilitate development of the sludge management regime, but in the absence or reforms in other parts of the system, this may not necessarily lead to significant changes to current practices.

We would therefore propose that Defra consider changes to the regulation of sludge so that the existing Biosolids Assurance Scheme (BAS) standard be used to determine the end-of-waste-position under environmental permitting. The BAS standard was developed to set the expected standards for the treatment of sludge and to promote and sustain the agricultural recycling route

[1] "Indigestion" refers to disruption to digestion processes when new waste streams are introduced

for biosolids. This would ensure a level playing field for all market participants, give greater certainty to agricultural businesses and consumers, allow a light touch approach to be applied (without any increase in administration costs) and create better conditions for trading in co-digestion markets.

Information requirements

We support the proposal to require publication of information on volumes, prices and quality. Our experience to date of attempting to trade with other water companies is that the lack of information prevents the identification and assessment of potentially beneficial trades. The requirement that this information be made available should help significantly in revealing opportunities for existing companies and new entrants. We suggest that all market players might be encouraged to share comparable data on the same platform.

We have some detailed comments on the specification of the data that is collected and discuss these in our response to question 2. There is work to do in finalizing the data tables. We welcome Ofwat's proposal to partner with companies to trial the development of the data and look forward to being an active participant in that partnership. We suggest that non-sludge organic waste producers and providers of organic waste treatment should also be included.

The purpose and form of the price control

Companies have always been incentivised to improve the efficiency of their sludge operations and the current regulatory regime preserves those incentives. The barriers to trade are not related to the form of the price control, rather they are linked to the difficulty of identifying potential trades because of the paucity of information. Given that Ofwat's proposals on information sharing should address this, <u>it is worth considering whether this could in itself drive the necessary changes to companies' behaviour, and that the introduction of a separate price control may be an unnecessary further complication</u>. We would like better to understand Ofwat's rationale for the separate price control, which would help us to consider what form an effective price control might take.

We note that setting a binding price control is dependent on accurate and consistent allocation of costs between sludge and other activities. Ofwat is currently assessing the consistency of companies' practices through its targeted review. We think that any decision on the nature of the price control should await the findings of this review.

RCV allocation

We would suggest specific workshops on the proposed approach to RCV allocation and stranding risk.

Ofwat's proposal on RCV allocation and its views on asset stranding are potentially significant, given the potential impact on the cost of capital for these elements of the price control. This warrants deeper discussion. We look forward to the proposed workshop on RCV allocation and to review this in greater detail in the light of that workshop.

Boundary between sludge and wastewater network plus

Having considered this issue in some depth, including trying to consider the position from the viewpoint of a potential entrant, we think that sludge transportation should remain within wastewater network plus, rather than within sludge.

Ofwat's proposal is for the boundary to be drawn at the sewage treatment works (STW) gate, which would therefore encompass the transport of raw sludge within the sludge control.

We would propose instead that the boundary should be drawn at the sludge treatment centre (STC) gate, so that sludge transportation would remain part of wastewater network plus. We believe this would both preserve existing synergistic benefits and create opportunities for entry. The compliance risk and potential fines associated with pollution events could also act as a barrier to entry. We set out our reasons in more detail in our response to question 1.

Bid assessment guidelines

We do not understand the need for bid-assessment guidelines, or for companies to justify their decisions on bids as Ofwat proposes. We believe that rational companies will assess bids on the basis of their potential for profit maximization. Indeed, this same assessment underpins Ofwat's conclusion that financial incentives for sludge trading are not required. The proposal to introduce guidelines therefore appears to be inconsistent with this and the statement in the consultation that 'companies need not engage in trading, should they choose not to do so'. We also note that there is a significant additional regulatory burden associated with this requirement, without clear upside benefits.

Additionally, we do not understand why companies should record details of bidding activity. Doing so could inhibit market development, given the desire for commercial confidentiality among market players. Whilst we appreciate that Ofwat will wish to observe the development of market activity, we think there are simpler and less burdensome ways for this to be achieved.

C. Water resources

Overview

Broadly, we welcome Ofwat's proposals on water resources and the moves towards a multi-company and multi-sector approach. This echoes the work we are taking forward with others as part of the Water Resources East Anglia project and on multi-sector financing.

We support moves to open up markets in water resources where these are genuinely contestable and agree that the sector needs a system that allows incumbents to recover efficiently-incurred costs while removing barriers to entry.

However, we do not accept some of the quantification of likely benefits, and we would note that there are some significant details yet to be worked out. We would like to work with Ofwat to take these points forward.

Benefits quantification

There is a need for more robust cost-benefit analysis on physical water trading, noting that there are significant existing river water transfer schemes. This should be agreed between Ofwat and the industry. It can then be used to assess the design of a proportionate information-sharing platform. The £1bn level of benefits cited is open to debate. We would suggest Ofwat and the sector work together, alongside the Environment Agency and the Drinking Water Inspectorate, to come to an agreed view on the likely scale of benefits.

Links to abstraction reform

We have argued in favour of abstraction reform for many years, recognising that more flexibility in trading of abstraction permits would help to ensure more efficient use of a scarce resource. We see abstraction reform as having greater long term benefits for resource efficiency and customer benefits than physical water trading, although we can also see these working in tandem effectively. We discussed these issues in detail in our February 2011 publication "Trading Theory for Practice". We would propose an incremental approach, linking to DEFRA's proposals on abstraction reform and focussed on removing barriers to desirable trades.

Impediments to physical water trading

The impediments to transfers that we see include:

- Water quality regulation, and in particular the duties of water companies under the Drinking Water Directive;
- Water Framework Directive (WFD) "no deterioration", the impact of clawback under the Restoring Sustainable Abstraction programme and the proposal to limit Time Limited Licences to actual abstraction levels will reduce the amount of water available for trading and create uncertainty about potential trading volumes (loss of headroom);
- Tension between the long term focus in WRMPs (aimed at looking at long term supply/deficit issues) and the much shorter timescales envisaged in this market, and;
- The costs of transportation.

These impediments prevented a trading scheme we had developed with Cambridge Water from going ahead.

D. Large schemes

Overview

We agree that direct procurement for very large projects could potentially deliver benefits for customers. This may be particularly relevant when thinking about very large scale resilience schemes, which could provide benefits to multiple stakeholders. We recently commissioned FTI Consulting to consider options for multi-sector financing of large scale projects which might serve more than one user. This report explored some of the advantages and disadvantages of different

financing arrangements and potential barriers to their use.[2] However, the current approach which allows water companies to manage risk and reduce costs across a programme of capital expenditure has delivered significant efficiencies which have been shared with customers through lower bills: at PR19, AMP5 programme efficiencies accounted for a fall in customer bills of 2.5%.

Assessing self-supply alongside other options

Notwithstanding the above, we believe that an option should remain to use single company RCV-backed funding as the vehicle for larger schemes if this is the most efficient outcome for customers. The consultation is not clear that companies would be able to fund such schemes through the RCV under such circumstances. We suggest this could be done by companies running a procurement exercise and assessing responses, but preserving the ability to choose a self-supply option where this represents the best value (considering costs of financing, transaction costs, and overall costs of delivery on a scheme-specific basis). We propose that this option should be permitted and that Ofwat clarifies this in its response to the consultation.

Thresholds

Whilst we agree that direct procurement may offer benefits in potentially allowing for more efficient delivery by a third party, there is also a trade-off against the benefits that flow from the situation where one company manages a portfolio of investments and can assess risk at both an individual project and wider programme level (with cost efficiencies also possible across a programme). The scale and efficiency of companies' investment programmes also varies, so some form of metric might be more appropriate than an absolute threshold. In any case, the metric or threshold should be carefully considered and be determined based on an expected cost-benefit assessment. A threshold of £100m might be too low to get this balance right for customers.

E. Cost assessment

Overview

In our June 2015 Market Place for Ideas paper, we provided our detailed views on the PR14 approach to cost assessment and proposals for PR19. In summary, our paper said that modelling on a totex basis was unsuccessful and should not be attempted again. We think it should be possible to model base operating expenditure and capital maintenance ("botex"), as Ofwat did for sewerage at PR14, and as the CMA did in the Bristol Water reference. We think this could then be supplemented with additional forms of evidence.

Improving datasets and cost models

We are keen to work collaboratively with Ofwat and other companies to define and collect a comprehensive and robust dataset and to develop cost models. We are pleased to note Ofwat's intention to work with the industry to define a standard modelling dataset. We look forward to

[2] Financing Multi-Sector Water Supply Assets, FTI Consulting, 2015
http://www.fticonsulting.com/~/media/Files/emea--files/insights/reports/fti-anglian-water-report-2015.pdf

participating fully in that initiative. We believe there is merit in triangulating using a variety of approaches, including disaggregated cost models.

We remain concerned about the risk of a collectively unrealistic efficiency challenge being set but are reassured to note that Ofwat acknowledges this risk (page 102) and recognises the need to ensure that, when aggregated, targets are robust and credible.

F. RPI / CPI

Overview

We recognise that CPI is now a more effective measure for indexation for use in the general economy. However, we believe that any change of indexation in relation to economic regulation of the water sector should ensure there is no negative impact on customers, and should recognise that the basis on which previous investment decisions have been made should not be retrospectively altered by any change. We recently published a paper in which we set out our views in detail on the question of moving from RPI to CPI, which has attracted significant support. This is appended as an annex to this response for ease of reference.[3]

Transition

Therefore, whilst we acknowledge the logic of moving to a CPI-based approach for revenues and the RCV, we believe this should be subject to a more gradual and flexible process than the model proposed in Ofwat's consultation.

Indexation of future costs (real price effects)

We believe it would be desirable for Ofwat to go back to first principles on the indexation of costs, and to consider how best to estimate companies' expected actual future costs. The established methodology in previous price reviews was to assess each element of the cost base, the expected inflation of those costs, and then to adjust by reference to RPI. If Ofwat follows this approach (substituting CPI for RPI), then a company should be indifferent to the use of CPI or RPI as the cost inflation measure. We note that the CMA, in its recent decision on the Bristol Water reference, recognised the importance of assessing real price effects.

Avoiding additional costs

We believe that Ofwat's proposal would leave companies needing to hedge, which would itself create costs that would then need to be borne by someone. Such hedging costs could be avoided by the approach that we have set out in our published paper. We believe this achieves the desired policy objective, whilst avoiding any negative impacts on companies, customers or debt investors.

[3] *http://www.anglianwater.co.uk/_assets/media/CPI_transition_v1.pdf*

G. Customer engagement

Overview

We are broadly supportive of the policy direction set out by Ofwat in its Water 2020 document, including the recognition that the progress made in PR14 can be improved upon in PR19. Stronger customer engagement, where qualitative and quantitative information is triangulated and assessed, should yield better outcomes that capture customer preferences. However, we think Ofwat could go further in a number of areas.

Ofwat's role in customer engagement

During PR14, Ofwat's involvement in customer engagement processes, both with Customer Challenge Groups (CCGs) and in assessing the material presented by companies, was very limited. We welcome that Ofwat has signalled more involvement for PR19, but would urge it to go further and embrace more fully the recommendations of the recent UKWIR report on customer engagement.

Ofwat could, for example, set out more clearly how it will assess good quality customer engagement. It could state that it will accept companies reaching differentiated positions within their business plans if there is clearly evidenced customer support, and signal the level of benefit that companies that have put additional resources and efforts into their customer engagement process may glean.

Ofwat should confirm that it will at an early stage in the process set out its views on the WACC, RORE, and efficiency levels. This would mean that that the "envelope" within which customer engagement can take place is understood. This would help CCGs to focus their efforts. Ofwat could also do more to set out at an early stage its "red lines" and "green lights" for the price review process; i.e. those areas where it feels the decision should be for the regulator alone, and those areas where it is willing to see conclusions that would primarily flow from good customer engagement processes. These could result in quite different outcomes for companies, depending on the preferences expressed by their customers. We believe doing so would allow a more tailored approach to customer engagement and yield more innovation.

We feel that, if Ofwat can demonstrate that it will place real weight on the outcomes from good customer engagement processes, this will both incentivise companies to strengthen further existing efforts, and make it more likely that people will be willing to serve as members of CCGs, or otherwise be willing to be involved actively in customer engagement opportunities.

H. Timetable

Overview

We are pleased to note that Ofwat intends to provide indicative Weighted Average Cost of Capital (WACC) and Return on Regulated Equity (RORE) ranges early in the process but would wish this to be confirmed. We would also suggest that an early view in efficiency ranges would be helpful. We are, however somewhat disappointed that Ofwat has not proposed a revised date for business plan submission compared with its July 2015 publication, and that discussions are still ongoing with other regulators. We welcome, however, the recognition that the price review process needs to align with other timetables, in particular the WRMP and NEP processes. We would suggest that a deferral of the date for the business plan submission, and an advancement of the date for the WRMP submission could allow for an alignment of submission dates around October 2018.

WACC and RORE ranges

We think that the timing of publication of WACC and RORE ranges is important, to ensure that companies can fully reflect Ofwat's views in their plans, and suggest that early in 2018 would be the appropriate time to issue these ranges. As we set out in our response to Ofwat's July 2015 publications, we also think it would be helpful to issue draft botex thresholds at the same time. This is so that companies can agree a firm baseline of investment for a large proportion of totex, allowing informed and focused engagement with customers over discretionary totex. Using an econometric modelling approach means that models can be developed early and then supplemented by data as it becomes available each year. Moreover, this does not preclude a risk-based review approach; there would still be an incentive for companies to set robust efficiency targets.

Timing of business plan submission

We agree that the business plan submission date should be brought forward compared with the PR14 process, and welcome Ofwat's intention to publish PR19 methodology before the end of 2017. However, we think an Autumn 2018 submission date would allow the incorporation of audited 2017-18 out turn positions in companies' financial modelling, which would not be possible with a July submission date.

Annex – Response to individual consultation questions

Q1 Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal?

We are not clear as to what purpose is achieved by the setting of a separate price control. We look forward to having a better understanding of Ofwat's thinking in this regard. These discussions will help us to consider what form an effective price control might take. In addition, we have some concerns that a separate price control could create complexities in relation to how companies ensure compliance with the Competition Act.

We note that setting a binding price control is dependent on accurate and consistent allocation of costs between sludge and other activities. Ofwat is currently assessing the consistency of companies' practices through its targeted review. We think that any decision on the nature of the price control should await the findings of this review.

Irrespective of whether a binding price control is set, we have a different view from Ofwat on where the boundary between sludge and wastewater network plus should be drawn. Ofwat's view is that the boundary should be drawn at the sewage treatment works (STW) gate and include the transport of raw sludge. Our view is that the boundary should be drawn at the sludge treatment centre (STC) gate and that sludge transport should remain part of wastewater network plus.

These are the reasons for our preferred boundary option:

- In most markets the responsibility for delivering commodities to market lies with the commodity producer rather than the buyer. Elsewhere in wastewater services we do not expect to collect trade effluent or other tankered wastes; these are brought to our STWs by their producers or firms acting on their behalf. It would also set a precedent in the waste industry, where waste producers are generally responsible for the transport of their waste to treatment providers.
- Our experience in the waste market tells us that the 'push' factors are stronger than the 'pull' factors. Waste producers focus intensely on the need to find an outlet for their waste, driven by the incessant nature of waste production and – often – a lack of storage capacity. By contrast, waste treatment providers face weaker incentives, as a period of inactivity due to lack of feedstock will have a less serious impact on their businesses. For this reason, it makes sense to assign the transport capacity with the party with greater focus on transport.
- Leaving the transport function with wastewater network plus does not necessarily preclude exposure to market forces as wastewater network plus always has the option to outsource this activity or employ a waste broker. Anglian has in the past outsourced its sludge tankering but brought it back in house to achieve greater efficiency.
- One of the purposes of the proposed reforms is to encourage water companies to contemplate purchasing sludge treatment services from suppliers other than their in-house operation. It is less likely that this objective will be met if the default service for transporting sludge away from its STW is the one provided by its own sludge treatment provider. If wastewater network plus retains the transport fleet there are fewer barriers to it switching to an alternative treatment provider.

- If the costs of transport remain with wastewater network plus it incentivises that part the business to dewater their sludges and so reduce the volume of water that is transported.
- Another purpose of the proposed reforms is to encourage organic waste treatment providers from outside the water sector to enter the sludge treatment market, and for new entrants to emerge. If these players are required to collect sludge from STWs rather than have it delivered it to them the barriers to their entry are higher.
- The tankers that we use to transport sludge are also used elsewhere in our wastewater service for sewage tankering. For example, in the event of a sewage pumping station failure we may use our sludge tankers to transport sewage, thus avoiding sewer flooding, pollution incidents or compliance failure. Compliance risk could increase in the market model Ofwat proposes. Maintaining the tanker fleet as part of wastewater network plus would mean that these beneficial synergies are not compromised and compliance risks are contained.

There is no discussion in Water 2020 about boundary options for the sludge price control but we think alternative boundaries should be considered before a decision is made. We note that our preferred boundary aligns with the one proposed by Wessex Water in its June 2015 paper.[4]

Q2 Do you agree with our proposal to make a range of cost, price, capacity and location information available to facilitate the identification of trades? Do you agree that the data should be published on a STC and STW site level? Do you agree that the data should be published annually? Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

Yes. Our experience in attempting to trade with other water companies is that the lack of information prevents the identification and assessment of potential trades. The requirement to make this information available should help significantly in revealing opportunities. We suggest other market players might also be encouraged to share comparable data on the same platform.

There is work to do in finalizing the data tables. We welcome Ofwat's proposal to partner with companies to trial the development of the data and look forward to being an active participant in that partnership. We suggest that non-sludge organic waste producers and providers of organic waste treatment should also be included.

Do you agree that the data should be published on a STC and STW level?

Yes, and we think we are well placed to report on this basis from our existing systems. It might be proportionate and helpful to the market to amalgamate data from very small STWs.

Do you agree that the data should be published annually?

Yes.

Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

[4] *Potential developments in the commercialisation of the sludge treatment and recycling market*, Wessex Water June 2015

It is helpful that the consultation document includes two tables to illustrate the type of information that is envisaged. However, we think that the draft tables include more information than would be necessary for the purpose of revealing trading opportunities. For Table 1 all that a prospective purchaser of sludge treatment would require is available capacity, treatment cost and STC location. The draft Table 1 includes information that might be necessary for other purposes (e.g. cost or efficiency assessment), but data required for purposes other than the facilitation of trade should be reported separately.

For this data publication approach to be successful it is imperative that the industry provides the correct information that the market needs and that each company reports in a reliable and consistent manner. The development of detailed reporting requirements will therefore be required.

A key metric for any discussion of sludge markets is the volume of sludge produced or treated. No common definitions of these metrics were agreed in the many years that companies reported them as part of the June Return process and agreement remains a key priority.

Another critical point to be agreed is the definition of 'average cost to treat'. Should this metric represent the marginal or average cost? Should it include opex or botex or should it be fully loaded to include capital charges and a return? Is our average cost to treat figure intended to be the same as a gate fee?

Furthermore we note that any figure quoted as 'average cost to treat' cannot be taken as a binding offer to another sludge producer. A treatment provider's appetite to receive sludge - and hence the price it will charge - will vary in time and according to the nature and quality of the sludge on offer. The gate fee offered in any prospective deal will be specific to the circumstances of the particular trade and subject to commercial negotiations. Any figures quoted in the tables proposed by the consultation will therefore be indicative.

Q3 Do you agree that the information should also contain details of 'bids' in from third party providers, and that there should be guidelines for ensuring that such bids are assessed on a level playing field basis?

We do not understand the rationale for guidelines on assessing bids. Rational companies will assess bids on the basis of profit maximization, which is why Ofwat proposes that financial incentives for sludge trading are not required. The proposal for guidelines therefore appears to be inconsistent with the proposal on financial incentives and the consultation's statement that 'companies need not engage in trading, should they choose not to do so'. We also note the regulatory burden associated with this requirement.

We do not understand why companies should record details of bidding activity. Doing so could inhibit market development, given the desire for commercial confidentiality among market players.

We also note the interaction on this point with EU procurement rules. These rules require that companies seeking to procure services advertise their needs and set out in advance their selection criteria. These rules are intended to promote market competition and to ensure a level playing field in the assessment of bids. Further rules may be unnecessary - or, indeed, present a conflict with actions that companies need to take to comply with their statutory duties and the Competition Act incentives to ensure a level playing field.

Q4 Do you agree that the data should be made available centrally through some form of information platform? Do you have any views as to how this might best be managed?

We would be happy to publish the information on our own website but recognise that it would make it easier for market players to find all the information in a central place. Using a central information platform might also enable the introduction of some form of data quality control. We suggest other market players might also be encouraged to share comparable data on the same platform.

Do you have any views on how this might best be managed?

We would be keen that the exercise does not cause us to incur additional costs. It is possible that companies could manage this exercise collectively and publish the information on WaterUK's website, as currently happens for other data collections.

Q5 Do you agree with our proposals not to make any changes to the status quo in relation to system operation activities?

Yes. It would be disproportionate to introduce an independent system operator at this stage.

Q6 Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?

Yes. The contribution that sludge trading can make to meeting companies' efficiency challenges should be sufficient without the need for further financial incentives.

Q7 Do you agree with our proposal to have a separate binding price control for water resources?

We accept the principle of separate price controls but note that Ofwat needs to have regard to the financeability of water companies as a whole, and that this should be clearly assessed across price controls.

We also have some concern about efficiency measures. Whilst we are always striving for further efficiencies across our business, incorrect cost allocation to different parts of the business could give a false picture of achievable efficiencies.

Q8 Do you agree with our proposal to implement an offset mechanism to ensure that entrants can recover the cost of new resources appropriately, while also ensuring that prices reflect average costs?

We agree that there is a need to avoid barriers to entry to the market and therefore accept the need for an offset mechanism. However, we question whether Ofwat's proposed mechanism is the most appropriate way to do it. We would expect this to be explored further as part of the future planned engagement on access pricing.

Q9 Do you agree with our proposals to create a market information database and bid assessment framework to allow for the 'bidding in' of third party resource options on an ongoing basis – as set out in the Deloitte Report?

We support the principle of supporting trading through a market information database and bid assessment framework. As mentioned elsewhere in our response, we are concerned that the consultation paper over-estimates the scale of the benefits of physical water trading. We want to see an information database whose cost is proportionate to the likely gains.

We agree that it is important that the range of data included in a market information database is comprehensive enough to enable participants to evaluate trading options. Much of the information to be provided by companies as suggested in the Deloitte Report is already available in published company Water Resource Management Plans and we would, therefore, support inclusion of long-term supply demand forecasts at WRZ level and details relating to preferred supply side options for new sources (approximate location, volumes and marginal costs). We do not agree with the Deloitte conclusion that this information should be updated more regularly than every five years, which is in line with the current WRMP process as needs will not change in the interim.

We would expect retailers to provide details about the location, volume and water quality (chemical composition) of the water source available for trading. In addition we would also expect information to be included about the reliability of water during drought (at defined return periods) and confirmation that there are no associated environmental sustainability issues.

Q10 Do you agree that a third party organization may be best placed to manage the information database?

Yes, provided costs are kept proportionate to likely benefits of trading. We need to further understand the role of the third party in the water resources database and/or handling of settlements to address the MEAV/RCV mismatch between entrants and incumbents.

Q11 Do you agree that measures should be introduced to increase transparency and certainty around security of supply for water trading? How can this objective best be achieved?

We welcome removal of barriers to trade, but think that there is more opportunity for trades between users in one area than for physical water between areas. We await the outcome of a number of projects examining these possibilities: the industry-led project on long term planning for water resources, the multi-sector work carried out by Water Resources East Anglia and Water Resources South East, Defra's work on abstraction reform and research proposed by the Environment Agency into multi-sector water resource use.

Q12 Do you agree with our rationale for allocating the RCV?

We believe it may be possible to achieve the desired policy outcomes without formal allocation of the RCV, which creates other effects. This is a critical issue which warrants detailed consideration. We look forward to discussing it with Ofwat and other companies at the proposed workshop on RCV allocation.

Q13 Do you agree with our proposed approach for allocating the RCV for sludge?

See Q12 above.

Q14 Do you agree with our proposed approach for allocating the RCV for water resources?

See Q12 above.

Q15 Do you agree with our proposal to address stranded asset risks by extending our commitment to protect efficient investment included in the RCV to 31 March 2020?

Yes.

Q16 Do you agree with our assessment that there is no prospect for stranded assets due to the proposed form of control for sludge and water resources for the 2020-25 period?

At this stage we reserve judgment on this question, pending discussions with Ofwat and other companies at the proposed workshop on RCV allocation.

Q17 Do you agree with our proposed approach of an income guarantee recovered through the network plus control for protection against the risk of stranding, if a mechanism is required? How do you consider that such a mechanism could be designed to provide a simple, transparent, largely ex ante mechanism that preserves incentives for efficiency?

See answer to Q16 above.

Q18 In relation to water resources, do you agree with our proposals to implement an approach based on the average cost of providing 'network plus' activities?

The answer depends on the approach to RCV allocation and the interaction between the Water Resources control and the Network Plus wholesale control. We will continue to work with Ofwat on this.

Q19 In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these? Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

As is the case now, companies are required to publish access prices in their Network Access codes. We agree that publishing at WRZ level seems appropriate and may link to other parts of the regulatory framework (WRMP) and future zonal developer charging approaches.

The level of cost disaggregation will need to be informed by the prevailing availability and quality of existing data and how this may change in future.

Q20 In relation to water resources, do you agree with our proposals to implement a mechanism that offsets the difference between the LRIC (or potentially the AIC in the absence of LRIC data) of new resource and the prevailing average cost of resource?

Ofwat are correct to acknowledge the potential challenges of capturing LRIC data. Both Q20 and Q21 relate to the development of potential future access pricing regimes. As stated in our main response, we are looking forward to exploring in greater detail with Ofwat in due course.

Q21 Do you further agree that it is the incumbent's, rather than the entrant's LRIC, that should form the basis of the payment, to provide a stronger incentive for entry?

See Q20.

Q22 In relation to sludge, do you agree that price and non-price terms should be the outcome of commercial negotiation, supported by the cost or price and capacity information previously set out?

Yes. We noted in our response to Q2 that any figure quoted as 'average cost to treat' cannot be taken as a binding offer to another sludge producer and that the gate fee offered in any prospective deal will be specific to the circumstances of the particular trade and subject to commercial negotiations.

Q23 Do you support our proposals to develop high-level guidelines as to how rival offers in relation to sludge treatment, transport and disposal should be evaluated?

See Q3.

Q24 Do you agree with our proposals relating to the use of direct procurement on behalf of customers?

Please see our main response. Whilst direct procurement for very large projects could potentially deliver benefits for customers, it is important that an option should remain to use single company RCV-backed funding as the vehicle for larger schemes if this is the most efficient outcome for customers. The consultation is not clear that companies would be able to fund such schemes through the RCV under such circumstances. This could be done by companies running a procurement exercise and assessing responses, but preserving the ability to choose a self-supply option where this represents the best value (considering costs of financing, transaction costs, and overall costs of delivery on a scheme-specific basis). We would suggest that this option should be permitted and that Ofwat clarifies this in its response to the consultation.

Q25 Do you have any views on our specific proposal to set a £100 million threshold above which point we would expect companies to procure at market on a standalone basis?

Please see our main response. Whilst we agree that direct procurement may offer benefits in potentially allowing for more efficient delivery by a third party, there is also a trade-off against the benefits that flow from the situation where one company manages a portfolio of investments. The scale and efficiency of companies' investment programmes also varies, so some form of metric might be more appropriate than an absolute threshold, and a threshold of £100m might be too low to get this balance right for customers.

Q26 Do you agree that our proposal for four binding wholesale price controls should apply to companies whose area is wholly or mainly in Wales, as well as to companies whose area is wholly or mainly in England?

Not an issue for us.

Q27 Do you agree with our initial view that the network plus controls for water and wastewater and the water resources controls should be total revenue controls?

Yes, this seems a reasonable approach.

Q28 Do you agree that future investment in relation to sludge treatment, transport and disposal should be exposed to volume risk and, accordingly, what are your views regarding the appropriate form of control in this area?

We agree that the objectives for the incorporation of sludge into the wider organic waste market will not be met unless future investment is exposed to volume risk. Devising the appropriate form of control is another complex area to which we would like further thought to be given. We would welcome discussions with Ofwat and other companies on this subject.

Q29 In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?

We note a potential difficulty in the use of totex cost recovery for investment in these areas post 2020. Prior to PR14 companies recorded expenditure as either opex or capex, with the latter added to companies' RCVs. In response to a perception that this arrangement encouraged a bias towards capital expenditure, Ofwat introduced a new mechanism at PR14 such that a fixed proportion of all expenditure was added to the RCV, irrespective of the nature of expenditure. This reform removed any ability for companies to exercise a capex bias. Companies were relatively relaxed about the reform as they were still guaranteed to receive a return on any expenditure they made, either via the RCV or on a pay as you go basis.

Ofwat has said that after 2020 capital investment in sludge and water resources will not necessarily be added to the RCV. Companies will be not be content with totex cost recovery, as a proportion of any expenditure will be treated as capital even if they decide that they do not wish to bear the risk of making new capital investment. This problem could be avoided by setting the PAYG ratio at 100% but this would introduce a whole new set of problems.

Our view is that in sludge and water resources we should revert to the pre-PR14 approach of remunerating cost after 2020. The totex recovery approach is no longer required because the perceived incentive to capex bias (that is, a no risk way of adding to the RCV with guaranteed return) has been removed. After 2020 there will be a disincentive for capital expenditure through the risk of not earning a return on the investment.

Q30 How can we best ensure that long-term contracting arrangements are not dis-incentivised – and that any continued application of a return on RCV approach for incumbents is on a level playing field with third party providers?

We believe this question is linked to the practicalities of access pricing and contracts, and that this should be further discussed in a dedicated workshop.

Q31 Do you agree with our proposal to retain our RBR approach for PR19?

We agree that the RBR approach should be retained for PR19, and think that it would be helpful to be clearer about the criteria used to assess plans, earlier in the process. We believe that a company's track record on performance and delivery should be a key element of this. It is also essential that the level of reward available to enhanced companies be very explicit at the outset of the process, so that companies know both the effort needed and the reward available to create an enhanced plan.

Q32 Do you agree with our proposal to reflect current performance in our RBR assessment (and for CCGs to consider this as part of their report?)

We think it is vital that current performance is part of the assessment of plans, as this is the key measure that can be used to assess whether companies will be able to deliver their PR19 business plans.

Q33 Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?

We think that, as we have done, company plans should clearly show the link between the current five year plans and the longer term strategic direction for the business, as set out in the Strategic Direction Statement (or a similar long term assessment).

Q34 Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?

Yes. It is hard to envisage how separate price controls, which incorporate assessments of efficient costs, can be set in the manner envisaged without disaggregated cost models. However, we are concerned that, in identifying frontier companies in each separate control, a collectively unrealistic efficiency challenge is set. We are pleased to note that Ofwat acknowledges this risk (page 102) and recognises the need to ensure that, when aggregated, targets are robust and credible. It is important that genuine triangulation of the results from whole service and disaggregated models (plus the results from any other form of cost assessment) is undertaken.

Q35 Do you agree that the development of detailed cost allocation guidelines is appropriate?

Inconsistency between companies in the way they allocate their costs is probably the main reason why we could end up with the unrealistic efficiency frontier described in our answer to Q34. Through error or a difference in its approach to cost allocation, one company could be responsible for the setting of an unrealistic benchmark across the industry. The development of detailed cost allocation guidelines is therefore essential to minimise this risk. We look forward to participating in this work.

Ofwat is still to make a decision on whether cost assessment for PR19 is undertaken on a collective basis with the industry or whether it will be left to individual parties, as it was at PR14. Regardless of the outcome of this decision, it is a fact that in order to do any modelling the industry needs a comprehensive and consistent set of financial and non-financial data. Termination of the June Return in 2011 has not served the industry well and the belated collection of data through the August Submissions at PR14 was a sub-optimal, if necessary, remedy. We welcome Ofwat's intention to work with the industry to define a standard modelling dataset and look forward to participating fully in that initiative.

Q36 Do you agree with our proposal to retain the current timings of our price controls – that is, not change the duration of wholesale price controls, not to stagger wholesale water and wastewater price controls and not seek to further align the timing of controls with other planning processes?

We agree with your proposals to retain the current timings of the price controls.

Q37 Are there any other measures, not considered above that could help to encourage a longer-term approach?

The approach to efficient cost assessment should be carefully considered in the context of the longer-term. Beneficial large-scale resilience expenditure may be delayed into future periods in order to meet current cost-thresholds. There is a natural tension between efficiency and one of the key ways to provide resilience: redundancy.

Some additional measures might be:

- additional scope for companies to propose transition expenditure;
- provide forward looking indications on direction of travel for future price reviews to give companies confidence to formulate plans which will remain appropriate;
- ensure that regulatory reform is sensitive to the need to remain attractive to investors over the long-term.

Q38 Do you agree that we should amend the licence to allow for in period adjustments for some or all of the following: outcome delivery incentives, revenues and cost sharing?

When we consulted customers during PR14, they were very clearly opposed to such in-period adjustments.

Nevertheless, we agree that the licence should allow for in-period adjustments for ODIs as this allows rewards or penalties for delivering good or less good outcomes for customers to be implemented quickly. However we do not agree that revenues, cost sharing or debt indexation should be subject to in-period adjustments. This is because the proposals would introduce greater volatility in customer bills within the period and reduce the transparency that customers have of medium-term bill levels, and the current five-yearly true-up is sufficient to provide a mechanism for rebasing.

Q39 Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?

We agree that RPI is now regarded as a less credible measure of indexation. In line with the recommendations made by Paul Johnson, we acknowledge that changes are required for future price reviews but believe that there are better ways of delivering this change than in Ofwat's proposed approach. We have published a separate paper (annexed to this response) in which we have set out an alternative mechanism which we believe would deliver the desired policy aim without any additional costs, or unintended risks, being created. We would commend this approach to Ofwat.

Q40 Do you agree with our proposal to implement a CPI based approach, for both revenues (prices) and the RCV, subject to a transition process?

We agree that a change from RPI towards a CPI (or CPIH) based approach should be implemented for revenues and the RCV after 2020. However, we believe that existing RCV should be transitioned in a gradual way, subject to a clear set of rules and principles over a transition period. This will give markets and investors much needed certainty about the long-term position.

Q41 Do you agree with our proposal to transition to CPI over time, both in terms of the overall method and the specific proportions of the RCV we are suggesting would remain indexed by RPI?

Whilst we agree that a transition over time is needed, we question the scale and speed of the proposed approach. We believe that existing 2020 RCV, which represents past investment, should continue to have RPI indexation applied. This would reflect the contractual agreements already in place. Companies have outstanding long-term liabilities linked to RPI which were undertaken to manage the financing risk posed by the fact that regulated revenues recover real financing cost, and funding of inflation is delivered over a long period through the indexation of RCV to RPI.

At the recent City briefing, Ofwat stated that any risk above the notional gearing level is for equity holders to manage. Further Ofwat stated that the Water 2020 proposals would protect the existing level of debt for a company with a notional gearing level.

However, the Water 2020 document also acknowledges that companies have raised RPI linked debt on the understanding that RCV was linked to RPI. We believe this raises issues about the guidance under which companies raised RPI-linked debt in the past, and not about the level of gearing at which the debt was raised. Companies had clear expectations that RPI costs would be reimbursed over a long period through the RCV. This led directly to the decisions made by majority of the companies in the sector to raise RPI-linked debt. In recent price reviews, Ofwat has assumed a proportion of companies' bills have been linked to RPI, which has enabled customers to benefit from the lower cash cost of this debt.

In response to the UKSA's consultation, HM Treasury said:

> *"The government remains committed to using RPI e.g. in existing index-linked gilts which currently run out to 2068, and HMT and DMO have a long-established practice whereby the market is consulted prior to the introduction of any new type of debt instrument"*

Given the commitment outlined by Government, it seems clear that RPI will continue to be published for the foreseeable future. It is therefore still a usable measure for legacy debt. The water industry's debt fully matures around 2065, with many companies having these very long maturities. The RPI debt market is well established with 25% (£270 billion p.a.) of DMO issuance in

the form of RPI bonds, and over £2 trillion of total defined benefit pension scheme liabilities in the UK, a vast majority of which is believed to be linked to RPI.

This has provided a very efficient way for companies to hedge their RCV and RPI cashflow exposures for the benefit of customers.

Whilst it is expected that a similar market in CPI will develop over time, there are current problems related to the illiquidity of this market. We therefore consider it appropriate that the move to CPI is transitioned in the most economic way, providing flexibility as the market develops, and not necessarily the quickest way that could lead to increases in customer bills.

The scale of change in the model proposed by Ofwat would:

a) almost certainly increase bills given the use of levers such as PAYG and Run-off rates are constrained by ratios and rating agency concerns which will impact financeability;
b) almost certainly increase costs and risk to the sector with a number of companies left with exposed unhedged positions (rating agencies have noted the proposed change as being credit negative), or having to purchase expensive hedging instruments;
c) result in possible financing difficulties as the CPI market may not be sufficiently liquid to accommodate the size of issuance the water industry requires (for example, during AMP6 the water sector is expected to raise over £5billion; the size of the total CPI market now is around £0.45 billion).

Given Ofwat's firm commitment to value neutrality, it would seem that the primary concern should be to seek to ensure transition to CPI is achieved at the lowest possible cost for customers and companies, rather than to seek to deliver the transition quickly. Ofwat's approach assumes the CPI debt market will develop quickly. However this is an unknown : it may or it may not. Our alternative approach provides more flexibility for Ofwat as the situation becomes clearer.

Q42 Do you agree with our commitment to ensuring that any such change is value and bill neutral in NPV terms over time in nominal terms? What steps could be taken to make this commitment as credible as possible?

Value neutrality is important to the stakeholders and we welcome Ofwat's firm pledge in this area. A key facet of value neutrality is that over the longterm, customers and companies face no additional costs than they would have done under the RPI regime.

The investor survey carried out by NERA shows a degree of concern from a range of stakeholders. Our own conversations with banks and rating agencies suggest that this primarily stems from:

a) investors seeing WACC-setting as a subjective process, and;
b) as the transition to CPI will take multiple AMPs, pressure to manage bills will supersede the principles of value neutrality.

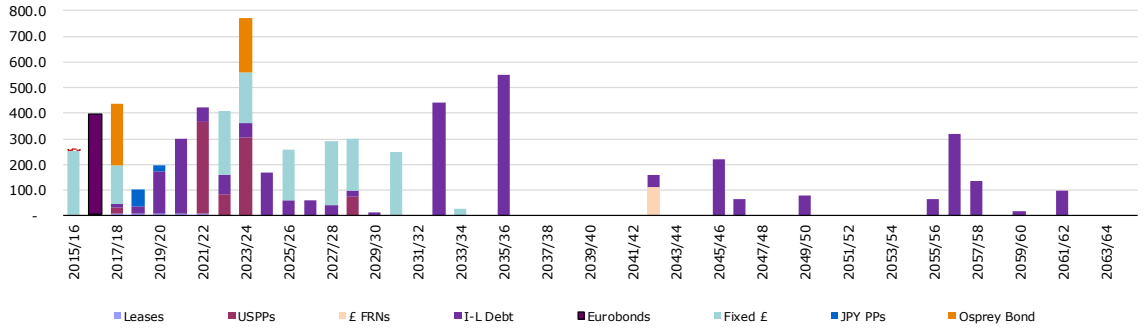
We believe the best way to ensure transparency is to separate existing RCV from the new commitments. Our proposed method follows a similar approach and tackles both these issues in a simple and transparent way. A number of companies, including from outside the water sector, have

informed us that they would be supportive of a transition on the lines we have outlined. This is also reflected in the recent NERA report.

To ensure value neutrality, hedging costs must be avoided

In our view, value neutrality and hedging of existing RPI linked debt go side-by-side. For the transition to be neutral overall, it must be free from any additional costs to the sector. If basis hedging is required, a new cost will be introduced that the industry would not have faced previously.

In our view a certain way to ensure value neutrality is by retaining some exposure to RPI, as a natural hedge to RCV, until all existing RPI liabilities have matured. This can be achieved if the transition is gradual and flexible to ensure no company faces mis-match of revenues and costs until the transition has completed. Our proposed method follows this principle.



Graph-1: Anglian Water's debt maturity profile as at 2015

The graph shows the maturity of Anglian Water debt that is linked to RPI. Given each company has a different debt maturity profile, it will be practical for companies, and for Ofwat, to allow the use of RCV run-off rates to run down the existing 2020 RCVs. This will accommodate the different RPI debt maturities for each company but still guarantee that the transition is achieved within a finite timeframe. All new commitments can be linked to a post 2020 RCV that would be subject to CPI.

Added together, a single RCV can be reported. This will mean that regular users of the RCV will understand the difference, just as they currently do with pre-2015 'old' and post-2015 'new' RCV.

Most importantly, this method ensures that the industry maintains a natural hedge to RPI until all the existing debt has matured. It also means that the speed of transition can be managed should a CPI market take longer to develop than anticipated. We believe our proposal provides a clear set of rules and principles under which transition can be implemented and gives investors much needed clarity over the full transition period. It also ensures the transition is value neutral (regarding the financing costs) and avoids the need for expensive hedging costs.

Q43 Do you agree that we should calculate the RPI linked element of the RCV based on forecast RPI with a true up at the end of the period to protect companies from changes in the difference between RPI and CPI over the control period?

Given the difficulty in forecasting the wedge between RPI and CPI, a well-designed true-up mechanism could help mitigate the risk. In our paper, we propose a true-up mechanism similar to that used previously by Ofwat for the true-ups between COPI and RPI.

It is worth noting that all our responses above assume that the UKSA retains CPI as the main UK national statistic. If CPI is replaced with CPIH, a further analysis should be undertaken, as there is no current market for CPIH debt, and one is unlikely to develop in the absence of demand for such debt instruments. This is because insurance companies and pension funds will transition from RPI to CPI rather than to CPIH.

Q44 To what extent does the current balance of risk and opportunities vary across the proposed wholesale controls and how does this impact on the cost of capital?

In general we think the impact on cost of capital will be to increase it (as the contestable elements will drive a higher WACC). However, we expect the overall impact to be relatively low. Nonetheless, if the RCV becomes more fragmented, this could reduce investor appetite for financing and increase the risk profile as perceived by the rating agencies, thereby also further increasing the cost of capital.

Q45 To what extent would our proposed market and incentive reforms impact on the balance of risk and opportunities and the cost of capital and would this vary across the proposed wholesale controls?

The Water 2020 consultation proposes the biggest change industry has faced since privatisation. Whilst we support the opening of markets where this clearly drives overall benefits, the full Water 2020 package is perceived to change the balance of risk and opportunities in the sector. Since the launch of the consultation, all 3 rating industries have assessed the quantum of changes to increase risk to the sector, and debt investors are expressing concerns. This was evidenced most recently in our recent US debt-raising initiative, seeking to refinance a maturing Euro-denominated bond. In our discussions in the US, the increasing risks of investing in the UK water industry were noted, with the proposed method of moving to CPI indexation being singled out as a particular concern.

The need for long term certainty

The Water 2020 proposals suggest a method of transition until 2025, but do not give details beyond this date. However, choices of approach to the indexation of RCV have a direct impact on financing strategies that are long-term in nature (some of the industry's existing RPI-linked debt matures after 2060)

As companies develop strategies to deal with the change, a key part of decision-making will be to understand the treatment of indexation of the RCV beyond 2025.

Ofwat's own WACC calculation assumes the proportion of embedded and new debt at 75%/25% which translates to an average debt maturity longer than 5 years. We believe that the transition to

CPI should take a similar longer-term approach and provide companies and investors clarity over the full transition period.

Q46 What does good customer engagement look like? What are your views on the principles outlined above? How could companies draw on good practice from within and outside the sector? How can companies make use of revealed preference techniques and information obtained in their day-to-day interactions with customers to develop a richer set of evidence of customers' needs and requirements?

We agree that companies should consider their relationship with customers and use information about customers as part of the ongoing process of delivering services, not just as an exercise related to any one price control.

As noted in our main response, a more holistic approach which draws upon regular information gathered by companies about customers, including through existing operations, should be considered alongside specific information related to the business plan, so that as informed a view as possible can be gathered, which can also be shared with the CCG. This needs to embrace qualitative as well as quantitative approaches, including, where possible, revealed preference exercises.

Q47 What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership? In relation to the quality of a company's customer engagement, do you agree with the above list of issues that should be covered by the CCG report? What are your views on the division of responsibilities between CCGs and Ofwat?

We are broadly supportive of the proposals in this area.

Q48 What are your views on our proposal to facilitate more collaboration between CCGs? What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early? Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?

As we set out in our response to the Water 2020 July document, we are strongly in favour of early publication of expectations around WACC and outcome RORE ranges. This will help to ensure that we can focus our engagement on areas where customers can have a meaningful influence. It will also help to ensure that companies' business plan submissions are able to focus on key areas of difference and discretionary investment.

Good companies see the inherent incentives in conducting excellent customer engagement – we do it to understand what our customers want, not just to meet regulatory needs. However, the best incentive that Ofwat can give to encourage even better engagement, is to place real weight on the outcomes of that engagement. If a company can demonstrate through high quality engagement that part of its plan is backed by strong customer support, then they should be confident that this part of the plan will be accepted by Ofwat and that heterogeneic outcomes between companies may be accepted. It would be helpful if Ofwat could confirm that a more nuanced approach will be taken in PR19 than that which applied for PR14.

Q49 How can the outcomes framework encourage a longer-term approach? Should we encourage, or even mandate, that certain measures - for example asset health – span more than a single regulatory control period?

We agree that companies should be encouraged to include longer-term (possibly non-binding) commitments in their business plans, and possibly to go further and to propose longer term incentives where this appropriate.

Our current approach to asset health is long-term by design already, so long as the approach is repeated in future price control periods. Failure to invest today in asset maintenance effectively would result in a deteriorating service for customers (not necessarily in the short-term), and penalties would apply until the level of service was restored. As upper-controls are based on previous good performance, penalties would be incurred in either this price-control or future controls, depending on the level of lag between company action and the effect on service.

Currently our incentives are all revenue adjustments. This is perhaps not the most suitable way to implement incentives spanning more than one control. Asset health, or long term resilience investment might be best incentivised through an RCV adjustment instead. However, we do not believe this would be appropriate for all incentives.

The UKWIR project "Setting performance commitments and incentives to deliver best value for money" due to report early in 2016 also considers long-term incentives. The findings of this report should influence Ofwat's thinking in this area.

Q50 What are your views on the proposed contents of our November 2016 consultation on outcomes (balance of bespoke versus comparative measures, and role of comparative information)?

We agree with the proposed contents of the November consultation.

Q51 What are your views on our proposal that companies submit the definitions – but not the targets or any associated incentives - for their performance commitments to us in early 2018 before they submit their business plans?

We agree that there are advantages to sharing proposed definitions for measures on which performance commitments will be based. However, if comparative measures are to be used, the definitions of those measures should be consistent, and as such they should be defined by Ofwat in early 2018. Without consistency of measurement no weight should be placed on comparative information, and where to apply comparison should be based on principles of where it is appropriate and effective to do so, not on measures which companies happen to define similarly when generated in isolation. We think there is scope for companies to work with Ofwat on proposing suitable measures and how they might be defined.

Q52 What are your views on our proposal for a licence modification to allow for the in-period payment of outcome delivery rewards and penalties?

We introduced an in-period incentive for PR14, and in certain circumstances this appears to be the right approach to incentive application. However, we would urge caution in moving too far towards in-period incentives, as our customer research has repeatedly told us that customers value stability

in their bills. Companies should have the freedom to choose the most appropriate balance based on their own engagement with customers, and to justify these choices in their business plan to Ofwat.

Q53 Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?

Broadly we agree with the potential changes and think that the most efficient process to achieve that change would be through agreement under section 13 of the WIA91. We have set out elsewhere in this response that we do not agree with automatic inperiod adjustments for cost sharing, revenue and debt indexation, as this increases customer bill volatility and decreases transparency of future prices for customers.

Q54 Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?

We agree with the steps laid out, and we think careful thought needs to be given to the asset valuation and assurance process to ensure that it is done in the most efficient and cost effective way possible, given that it is a new requirement that is not included in PR14 totex plans.

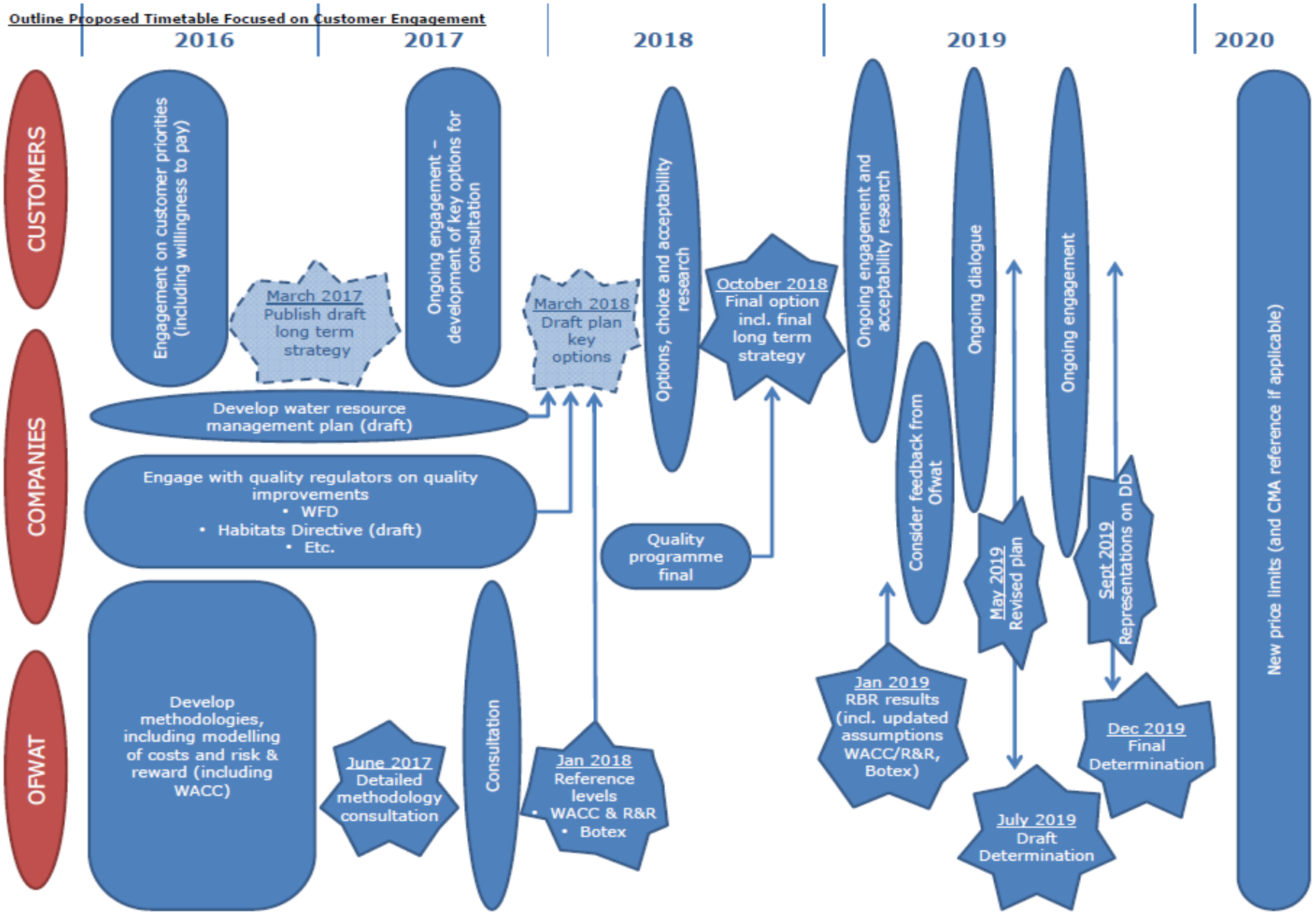
Q55 Do you agree with our indicative timetable for the Water 2020 programme?

We are pleased to note that Ofwat intends to provide indicative WACC and RORE ranges early in the process. We think that the timing of publication is important; to ensure that companies can fully reflect Ofwat's views in their plans, and suggest that early in 2018 would be the appropriate time to issue these ranges. As we set out in our response to Ofwat's July 2015 publications, we also think it would be helpful to issue draft botex thresholds at the same time. This is so that companies can agree a firm baseline of investment for a large proportion of totex, allowing informed and focused engagement with customers over discretionary totex. Using an econometric modelling approach means that models can be developed early and then supplemented by data as it becomes available each year.

We are somewhat disappointed that Ofwat has not proposed a revised date for business plan submission compared with its July 2015 publication, and that discussions are still ongoing with other regulators, although we welcome the recognition that the price review process needs to align with other timetables, in particular the WRMP and NEP processes. We agree that the business plan submission date should be brought forward compared with the PR14 process, and welcome Ofwat's intention to publish PR19 methodology before the end of 2017. However, we think an Autumn 2018 submission date would allow the incorporation of audited 2017-18 out turn positions in companies' financial modelling, which would not be possible with a July submission date.

We include below our view of a timetable for PR19 which would ensure sufficient time for customer engagement, which we have previously included in our response to the July 2015 publications.

Suggested timetable focussed on customer engagement



Note: Dotted outline indicates optional documents

Potential approaches for transition from RPI to CPI (updated)

Contents

1) RPI remains key to the water industry

- RCV and its linkage to RPI has been fundamental to the success of the water industry. Any change from the current approach should be subject to a full impact assessment that considers all of the issues.
- Water industry has long dated RPI linked liabilities - some maturing after 2060. A premature move to CPI could be detrimental as the market for CPI debt is undeveloped. DMO (debt management office) are currently not issuing CPI debt.
- Our first paper discussed how a change of indexation of the existing RCV could result in a mismatch of revenues & costs and potentially harm investor sentiment (similar views have also been raised by key stakeholders* since).
- If a decision is made to move to CPI then the transition should be gradual, and possibly flexible, to give companies an opportunity to manage the hedge between their revenues and costs. This has been a key attraction for investors that has allowed companies clear access to markets at attractive terms – benefits of which are passed on to customers (lower bills at PR14 was one example). Every effort should be made to retain and build on that investor confidence.
- Our proposed approach (explained in further detail in this paper) mitigates many of the credit concerns raised and will allow companies the flexibility to transition at a pace that aligns to the maturity of their RPI liabilities.

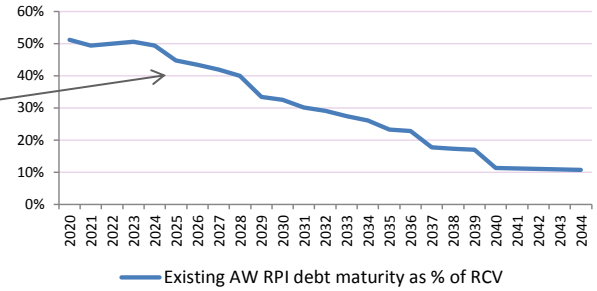
* Standards & Poors: *Proposed U.K. Water Regulatory Changes Could Dilute Utilities' Credit Quality*

Transition options

2.a) Ofwat proposal: convert 50% RCV at March 2020 to CPI

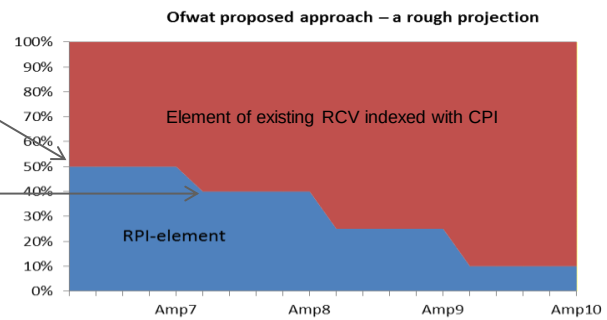
- Retain 50% linkage to RPI and intention to reduce RPI indexation in future
- Transparent method to calculate WACC on the basis of RPI and CPI.
- RCV proposed to split 50/50: this seems to imply that the element of RCV indexed by RPI continues to grow in nominal terms (new capex added equally to RPI and CPI element of the RCV). This is relevant for companies to implement risk-management processes.

- Graph shows maturity of Anglian Water's RPI linked liabilities as percentage of estimated RCV.
- A reduction in RCV indexation of RPI below these levels will require expensive hedging arrangements.



Ofwat proposal – existing RCV 50% CPI

If RPI indexation is reduced further whilst grandfathering existing RPI liabilities, future transition could follow a path similar to this (assume hedging costs are avoided..



2.b) Hybrid approach : create new 'CPI-RCV'; let existing 2020 RCV depreciate over time

- In this option the linkage to RPI is retained for the existing 2020 RCV. This is then allowed to depreciate naturally with companies in control of the speed of transition through the use of run-off rates.
- New 'CPI RCV' is created. This gives a clear distinction between new and historic assets. Companies can choose to draw run-off (depreciation) predominantly from the RPI-RCV to accelerate the transition.
- As the existing RCV runs off, over time companies can re-finance RPI liabilities without the need for expensive hedging.
- Companies already manage PAYG and run-off rates (financeability tools); under this approach companies will also manage the transition to CPI. Given companies have different levels of RPI liabilities with varying maturities, it is sensible for companies to own the transition.

Pros

- Suitable for WASC's and WOC's (companies to take control of their plans including speed of transition to CPI)
- No spike in customer bills
- No mis-match of revenues & costs
- No hedging required. Allows time to manage transition in an orderly manner
- Allows time for CPI market to develop

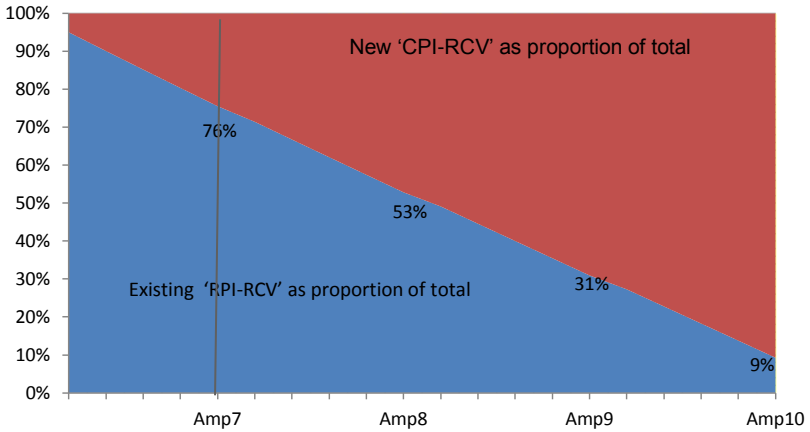
Cons

- RPI retained for a period of time (discussed in next slide)

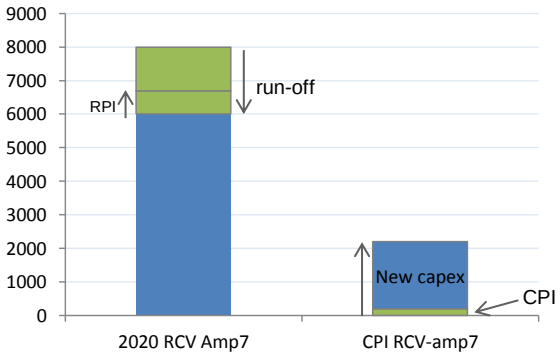
2.b) How long before 2020 RPI-RCV is fully depreciated?

- This depends on a number of factors, key being: 1) level of prevailing RPI 2) level of RCV run-off* rate.
- If all new capex is added to the new 'CPI RCV', and all run-off was drawn from the existing '2020 RPI-RCV', we estimate that after 4 AMP periods, 'CPI RCV' will represent around 90% of the total RCV* (see graphs below).
- In response to the consultation by UK Statistics Authority, HMT reaffirmed that Government is commitment to use RPI untill the existing gilts mature in 2068. Given water industry's debt maturity follows a similar time-frame (Anglian's existing RPI debt matures in 2062) retaining some RPI exposure to provide a natural revenue/cost hedge makes economic sense.

Total RCV (all run-off drawn from existing 'RPI-RCV', all new capex to 'new CPI RCV)



An estimate how an initial RCV of say £8 billion may evolve over AMP7

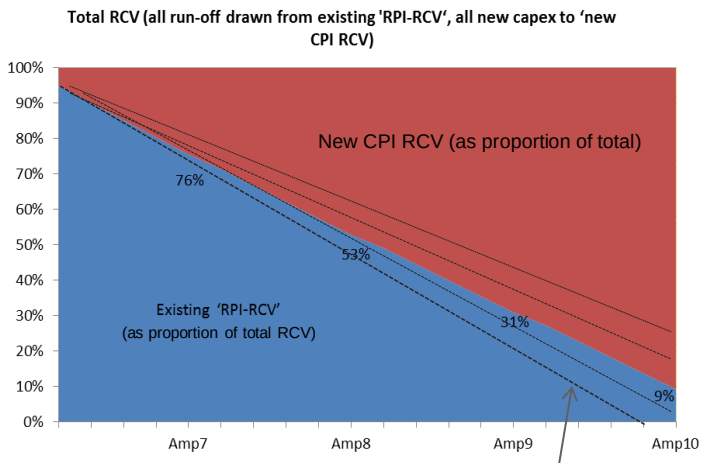


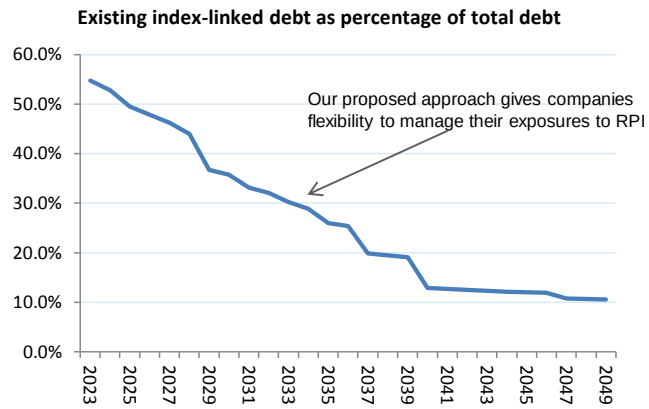
** RCV run-off represents the use & maintenance of assets during an AMP period*

*** Assume RPI =2.5%, RCV run-off =5%, Changes to these variables could accelerate or slow the transition*

2.b) Why companies need flexibility?

- Our example on the previous slide assumes a uniform depreciation of existing 2020 RPI-RCV. Around 55% of Anglian Water's existing debt is linked to RPI (c50% as a proportion of RCV); if grandfathered, we estimate that at 2040 this could still be between 10%-15% of total debt at the time.
- However, industry has varying levels of RPI debt obligations and maturities. Our proposed approach gives each company the flexibility to draw down existing RPI-RCV at a pace that supports their financing requirements.
- Companies already manage PAYG/run-off rates, this will be an extension of that existing flexibility which would allow companies to own transition and therefore manage financeability. This will mitigate revenue/cost mis-match issues discussed in our previous paper (also raised by S&P*).



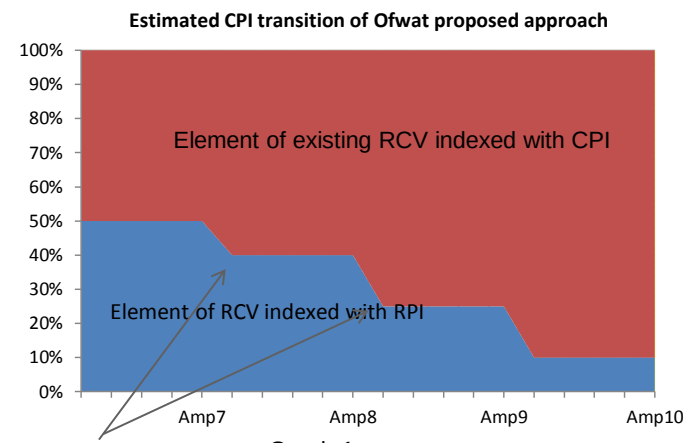


Companies may choose to align pace of transition to maturity of their RPI exposures

* Standards & Poors: *Proposed U.K. Water Regulatory Changes Could Dilute Utilities' Credit Quality*

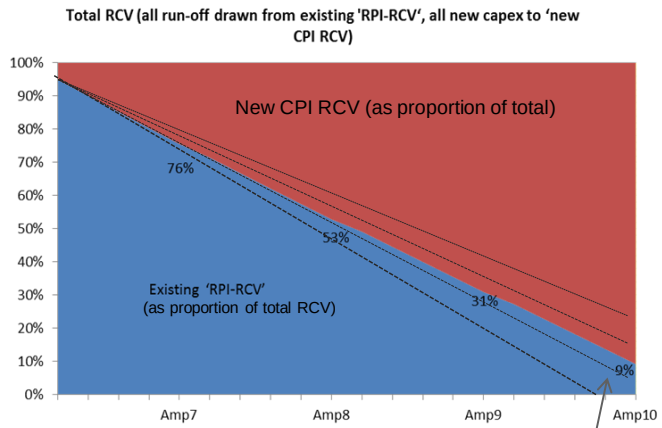
3.a) Which approach best balances risk and interests of the industry?

- By 2020, we estimate that industry's RPI linked debt liabilities will be around £30billion (financing strategies already in place, CPI market undeveloped), some of that existing RPI linked debt will mature after 2060.
- It seems safe to assume that RPI will need to be retained for a significant proportion of RCV to maintain a natural revenue/cost hedge. (We remain of the view that synthetic hedging will be expensive and inefficient and therefore should be avoided).
- One fixed solution will not suit all companies due to factors discussed earlier (varying RPI exposure and maturities etc).
- **Given the diversity of RPI exposures, companies should be allowed the flexibility and tools to manage their respective transitions.**



Grandfathered RPI liabilities to remain in near future

Graph-1



Graph-2 (Hybrid approach)

Transition flexibility will help maintain investor sentiment & keep bills low

3.b) Our proposed approach provides an effective mechanism

Meets customer needs ✓

- ✓ no immediate rise in bills
- ✓ no synthetic hedging required
- ✓ maintains regulatory stability (in long-term interest of customers)

Works for investors ✓

- ✓ no mismatch of revenues and costs
- ✓ allows time for CPI market to develop
- ✓ no synthetic hedging required

Aligns with the position of ONS & UK statistics ✓

- ✓ provides a timeframe for the replacement of RPI

Almost guarantees a value neutral WACC ✓

- ✓ completely separates CPI WACC & RCV
- ✓ provides future clarity & Regulatory certainty

Financeability & Affordability ✓

- ✓ companies in control of the transition

Summary

- Ofwat proposal alleviates some concerns however a number of issues remain.
- If a decision is taken to move to CPI then the transition should be gradual and flexible to give companies an opportunity to manage the hedge between their revenues and costs.
- Given a move to CPI will have a direct impact on affordability & financeability, it seems sensible that companies should own the tools to manage the change.

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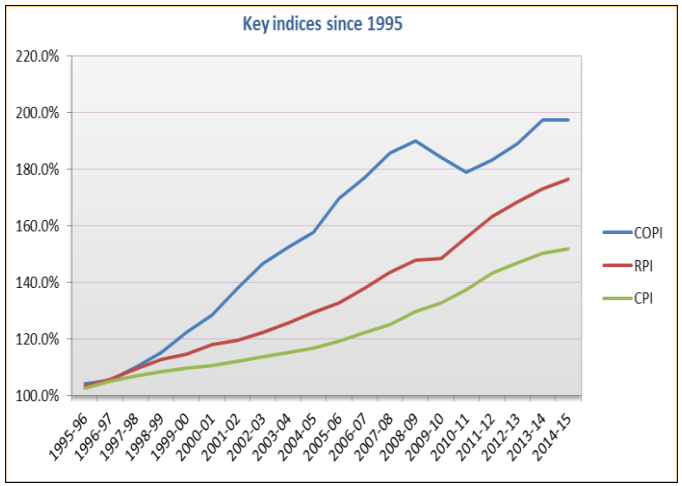
Appendix

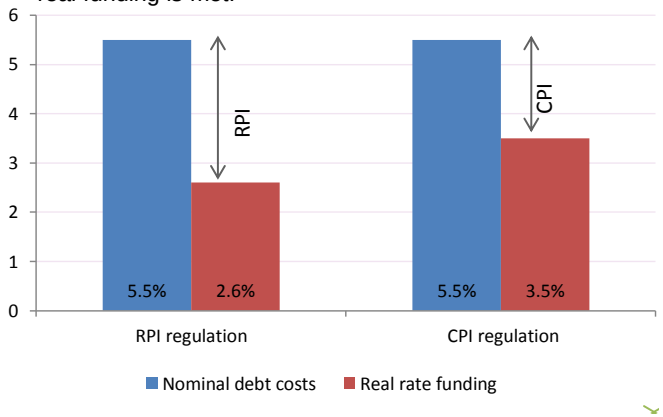
1) Key Implications of change (for companies, customers and stakeholders)

- **Existing RPI linked debt** : A move to CPI will create a disconnect between revenues and existing costs (slide 6).
- **Higher bills**: Customer bills will increase on transition to reflect 'real' CPI funding (impact can be softened by altering PAYG).
- **Cost assessments:** Companies plan their expenditure and funding in terms of RPI . A move to CPI means price-review models will need to capture underlying real price pressures to reflect the change of index (see graph).
- **Financeability –** Financeability testing will become the key focus for stakeholders as future WACC funding will reflect CPI, while large proportion of costs are likely to remain nominal or RPI linked (market for CPI debt is in infancy). Notional financeability tests may need to be redrawn.

Cost assessments: A move to CPI could reduce cash totex funding unless modelling reflects the change appropriately.



Nominal costs vs Real funding: Ofwat's financing duty ensures the gap between the nominal costs & the real funding is met.



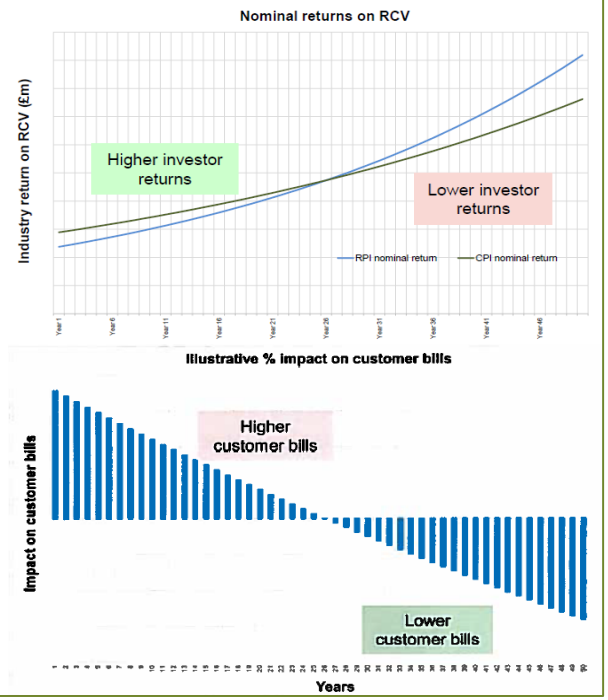
2.a) Full change to CPI – Key issues

➢ Ofwat noted that RPI linked liabilities may need to be hedged - 'it will not be costless'

Key issues with this approach

1. **Mismatch of revenues and costs** : (see page 5).
2. **Hedging** is prohibitively expensive – very limited market. Who pays?
   - This will be a new layer of banking costs that neither customers nor companies should bear given change is driven by external factors.
3. **Retrospective**– RCV's linkage to RPI is deeply embedded in markets.
4. **Bill impact:** a straight change to CPI will mean bills may have to rise by around 8% in real terms.
   - Changing PAYG can solve bills in the short-run however long-term financeability concerns will remain (see page 5).
   - If CPI does not recover from current levels, bill impacts could be much larger.
5. **Financeability:** Ofwat's financing duty will become ever more important with the mis-match of revenues and costs.
6. **CPI market not developed:** Companies have large financing needs. CPI market is still in infancy .

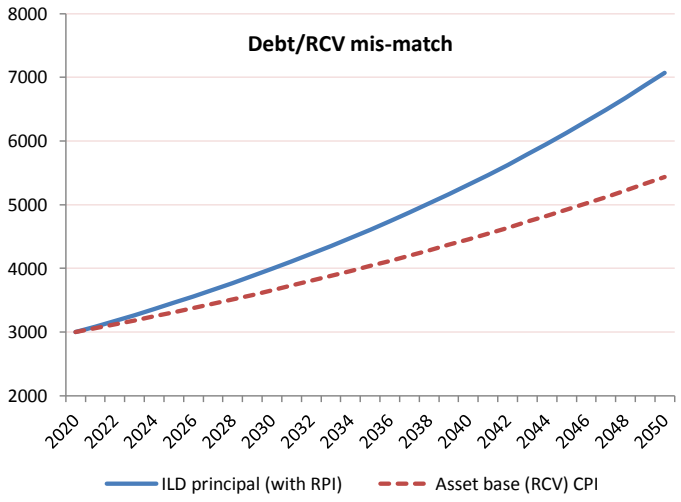
Graphs from Ofwat presentations



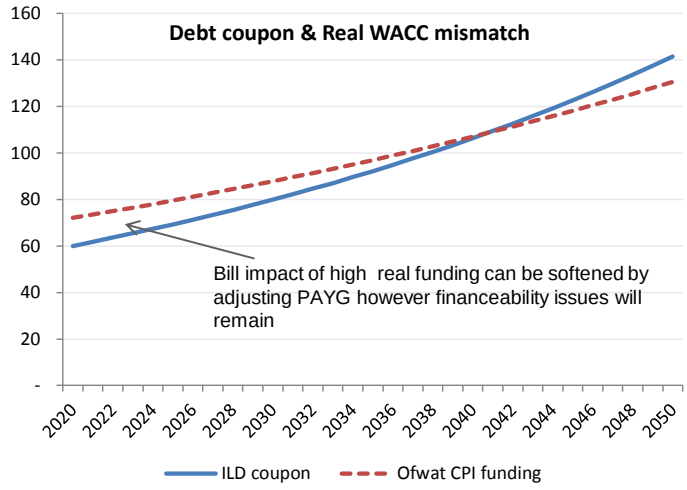
2.b) Full change to CPI - Cost / funding mismatch

- **Existing RPI linked debt**: A move to CPI will create a mismatch between revenues and costs.
  - Debt principal, linked to RPI, to grow faster than the corresponding asset base (CPI) creating an asset/liability mismatch at maturity. See graph 1.
  - Real funding will be higher in early years (CPI-WACC). See graph 2.

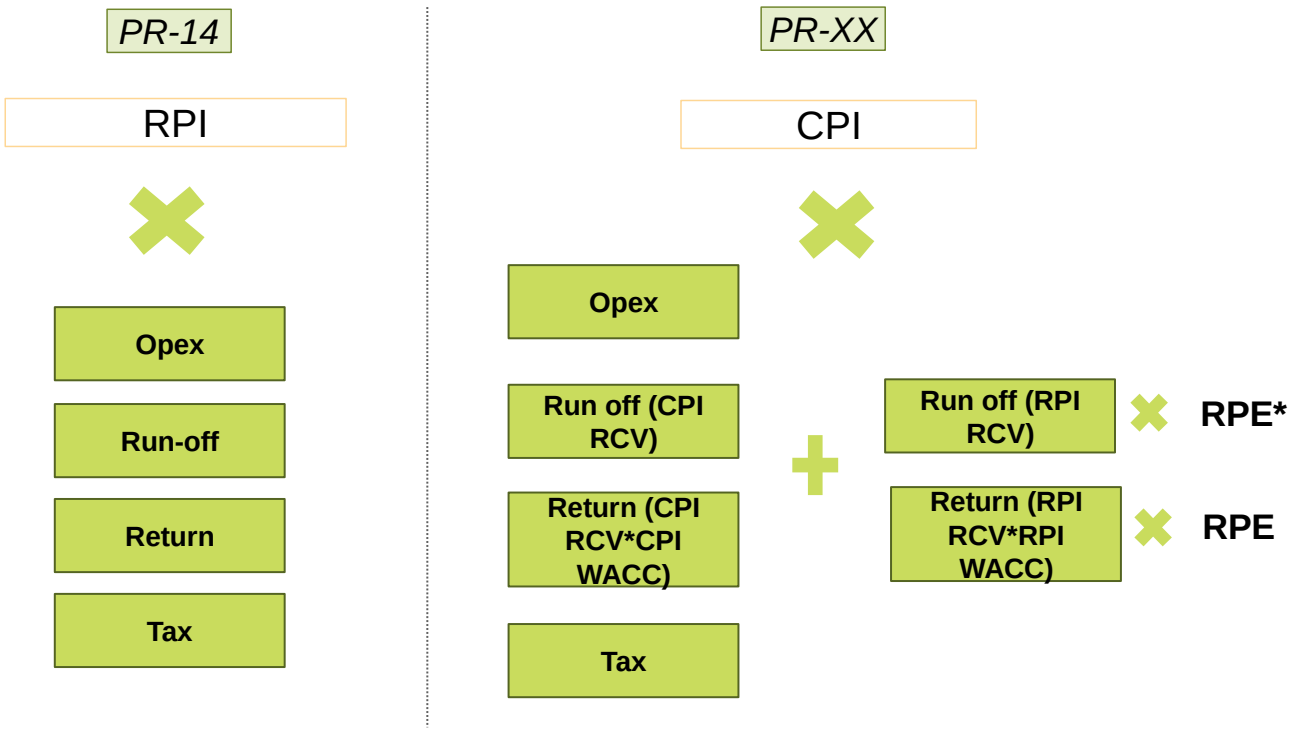
Graph 1



Graph 2



2.c) Financial Modelling of the Building blocks in CPI terms



* *Relative Price Effect*