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Trust in water

# **PR19 initial assessment of plans: Anglian Water company categorisation**

## About this document

In '[Delivering Water 2020: Our final methodology for the 2019 price review](#)' (the methodology) we said that we wanted all 17 regulated water and wastewater companies to produce high-quality, ambitious and innovative business plans, pushing forward the performance and efficiency of the sector for customers. To encourage this we developed the initial assessment of business plans (IAP) process. The IAP was designed to incentivise all companies to produce well-evidenced plans that reflect their customers' preferences and priorities and are efficient.

We explained that the IAP would:

- assess company business plans against nine key test areas that reflect our PR19 themes and the strategic policy statements of the UK and Welsh Governments and help make sure companies deliver for customers, the environment and wider society;
- assess company business plans against three key characteristics (quality, ambition, and innovation); and
- categorise company business plans into four categories (significant scrutiny, slow-track, fast-track, or exceptional).

Following the submission of companies' business plans on 3 September 2018, we have carried out an extensive and detailed review of these plans. This review has been carried out in accordance with our methodology. More details on our overall approach to the initial assessment of business plans and our key findings by test area are set out in the 'PR19 initial assessment of plans: Summary of test area assessment'. The results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation'. Our assessment is based on the information the company submitted to us as part of its business plans for the period 2020-25. The documents we have published are available on our [website](#).

This document sets out our assessment of Anglian Water's business plan submission under the IAP. It explains our assessment of the company's plan in the round at an aggregate level and our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the 'Anglian Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

# 1. Overview of Anglian Water's categorisation

## Our assessment of the plan

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that their dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet the needs of future customers and protect and improve the natural environment. We indicated in our PR19 methodology that the bar is high, and our Initial Assessment of Plans is the categorisation of company plans against those high expectations at this stage of the price review process. Where our expectations have not been fully met, we will continue to work closely with companies during the draft and final determination stages.

We categorise Anglian Water as slow-track. This categorisation was made after an in the round consideration of our assessment of Anglian Water's plan across the nine test areas and the overall level of intervention required in its plan to protect the interests of customers. Our grades for each of the test areas are set out in Table 1 below.

Anglian Water's plan shows high quality, ambition and innovation in its approach to customer engagement. It is the highest graded company in the engaging customers IAP test area. It uses a wide range of customer engagement techniques, and shows innovation in its willingness to pay research, a sector-leading approach to customer participation and research on resilience and intergenerational fairness, with a clear line of sight between the results of its research and financial incentives;

Anglian Water's plan includes other aspects of high quality, including:

- **affordability and vulnerability** - with the company ambitiously increasing the scope of support for those struggling to pay their bills and putting forward a sector-leading proposal to increase the number of people on its priority services register (PSR) to 15% of all customers;
- **delivering outcomes for customers** - with the company proposing a package of stretching performance commitments, with upper quartile targets for leakage and internal sewer flooding, and an outcome delivery incentive package with outperformance payments and underperformance payments calibrated to what its customers value the most;

- **targeted controls, markets and innovation** - with the company putting forward ambitious proposals for the increased use of markets to deliver catchment schemes, and evidencing it has the right culture and processes in place to encourage innovation; and
- **accounting for past delivery** - demonstrates a high quality approach, with sufficient and convincing evidence on measures to support the deliverability of the 2020-25 plan given past performance.

However, Anglian Water's plan falls significantly short in two areas. We have substantial concerns with the efficiency of Anglian Water's costs. Both its base and enhancement costs are more than 20% above our view of efficient and justified costs. Its projected wholesale water costs are more than 30% above our view of efficient costs and its wholesale wastewater costs are 19% above.

We also have substantial concerns about the assurance of Anglian Water's plan. There is insufficient evidence that the majority of the required Board assurance statements are from the Board and not the company. This substantially reduces our overall confidence in the assurance in the plan and raises concerns over Board ownership of the plan. We also have concerns on executive pay, with insufficient detail on signalling of future changes; and on dividend policy, with insufficient detail on how performance for customers will be accounted for.

We also have a number of other concerns with unconvincing evidence in aspects of Anglian Water's proposals in the areas of long-term resilience and risk and return.

Given the scale and scope of these concerns, the company's plan requires a level of material intervention to protect customer interests. We therefore categorise Anglian Water's plan as slow-track.

An overview of our assessment of the business plan in relation to the nine test areas and our grades for each test area are set out below. Our detailed assessment of the test areas is provided in the Anglian Water: Test area assessment and Anglian Water: Test question assessment.

**Table 1: Overall test area assessments**

Test Area	Our assessment
Engaging customers	A
Addressing affordability and vulnerability	B
Delivering outcomes for customers	B
Securing long-term resilience	C
Targeted controls, markets and innovation	B
Securing cost efficiency	D
Aligning risk and return	C
Accounting for past delivery	B
Securing confidence and assurance	D

A = High quality, ambitious and innovative plan with evidence that overall is sufficient and convincing

B = High quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing

C = Concerns with the plan: Plan falls short of high quality and/or evidence is insufficient and/or unconvincing in some areas

D = Substantial concerns with the plan: Plan falls significantly short of required quality and/or little or no evidence, or no convincing evidence

### Engaging customers

Anglian Water's plan provides a wide range of convincing evidence to demonstrate a high quality, ambitious and innovative approach to customer engagement and participation. It also provides convincing evidence of how customer engagement has been reflected in the business plan and in ongoing business operations.

The company's plan provides convincing evidence of the effective use of a wide range of customer engagement techniques including innovative multi-stage willingness to pay research. It demonstrates engagement with its customers on longer-term issues and its ongoing operations. This includes research on plan acceptability, resilience and intergenerational fairness. It also demonstrates how it has taken the needs and requirements of future customers into account in its plan.

The company demonstrates a clear line of sight from the results of its customer engagement to the outcomes in its business plan. Its performance commitments are based on robust customer valuation research with incentives that reflect customer preferences and priorities.

### Addressing affordability and vulnerability

Overall Anglian Water's plan provides convincing evidence to demonstrate a high quality approach to addressing affordability of its bills and how it intends to support customers in vulnerable circumstances.

The company had high quality engagement on overall affordability and the proposed 1% bill increase is below what customers were willing to pay according to the evidence provided. It proposes to support 500,000 customers who struggle to pay and suggests a sector-leading increase in Priority Services Register membership to 15% of customers by 2024-25. It demonstrates high quality engagement on long-term bills, including testing bill profiles from 2025 to 2030.

The company's plan falls short of high quality where it proposes performance commitments related to vulnerability that have an outperformance payment but no penalty for failing to meet its commitments. It has no performance commitment on affordability.

### **Delivering outcomes for customers**

Anglian Water's plan is generally of high quality in this area. The company proposes a balanced package of performance commitments that reflect customer views with appropriately stretching levels, particularly for leakage and internal sewer flooding. It provides evidence of a high quality package of outcome delivery incentives with outperformance payments and underperformance payments calibrated to what its customers value the most. It demonstrates clear consideration of how it will protect its customers if incentive payments are higher than expected.

There are areas where the company's plan falls short of high quality. It proposes a large number of limits on its financial exposure in relation to its PCs and ODIs, but does not convincingly explain why these are appropriate and in customers' interests. The overall outcome delivery incentive package proposed may incentivise the company to focus on a few performance commitments, rather than all performance commitments that are important to customers. It also does not clearly explain how it plans to report common performance commitments in line with our reporting guidance, particularly for unplanned outages.

### **Securing long-term resilience**

Overall, Anglian Water's plan falls short of high quality and it does not provide sufficient and convincing evidence of securing long-term resilience.

There is limited evidence that the company has undertaken a systems-based approach to resilience to identify system interdependencies and to prioritise risks appropriately. It proposes options to identify risks and mitigations that are not clearly linked within its resilience framework. There is limited evidence of the quantitative methods it uses to assess risks.

There is insufficient evidence that the company has considered the impacts of all the financial risks it may face including its assessment of the funds from operations (FFO)/net debt ratio and subordinated debt refinancing risk.

However its plan demonstrates that it has a comprehensive and well-structured baseline resilience assessment, a wide range of options to mitigate risks to resilience, and an effective approach to asset health and incident management.

### **Targeted controls, markets and innovation**

Overall, Anglian Water's plan is of high quality in this test area, provides sufficient and convincing evidence across most areas of targeted controls, markets and innovation.

Its plan includes strong evidence of a culture of innovation across most areas. Its proposed use of markets for its water and wastewater networks is ambitious and innovative, for example the Slug It Out scheme uses sector-leading techniques when engaging with the market.

There is uncertainty related to the scheme it proposes as part of its direct procurement for customer's assessment as the scheme was not included as a preferred option in its draft water resources management plan. The information it provides on the potential impacts of bilateral water resources market opening is limited. The company's plan provides insufficient evidence of engagement with third party providers of bioresources services.

### **Securing cost efficiency**

Overall, Anglian Water's plan falls significantly short in this area. Both its base and enhancement costs are more than 20% above our view of efficient and justified costs. The company's projected costs are more than 30% above our view of efficient costs in wholesale water and 19% above in wholesale wastewater. However its retail costs are close to our view of efficient costs.

The company proposes to reduce leakage beyond upper quartile performance levels. We have made an associated cost allowance for the proportion of its ambition that is above upper quartile.

In relation to the use of cost adjustment claims, the company performs well because it only proposes two claims. One is not high quality and we reject the basis of the claim. The other, frontier leakage reduction, has a partial allowance based on our view of costs.

### **Aligning risk and return**

Overall Anglian Water's plan falls short of providing convincing and high quality evidence to support its approach in the area of aligning risk and return.

Further assurance is required that the business plan is financeable on its actual capital structure given the funds from operations (FFO)/net debt financial ratio and the stated investment required. There is also insufficient evidence on its risk management and risk mitigation measures in its return on regulatory equity (RoRE) analysis.

However there are a number of aspects of its plan which are high quality. The plan is based on our 'early view' cost of capital and retail margins. It provides convincing evidence to support the Board statement that the plan is financeable on the notional financial structure. There is convincing evidence to support the company's choice of pay as you go (PAYG) rates and regulatory capital value (RCV) run-off rates.

### **Accounting for past delivery**

Anglian Water's plan demonstrates a high quality approach, with sufficient and convincing evidence both in support of PR14 reconciliations and on measures to support the deliverability of the 2020-25 plan given past performance.

### **Securing confidence and assurance**

Overall, Anglian Water's business plan falls significantly short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area.

The company's Board only provides a small minority of the requested Board assurance statements. The Board only signs a sub-set of the assurance statements with insufficient evidence that the Board itself provides the other requested statements. This substantially reduces our overall confidence in the assurance in the plan and raises concerns over Board ownership of the plan.

Its plan does not provide enough evidence that the company will meet the expectations that we set out in our 'Putting the sector in balance' position statement. On dividends there is a lack of evidence on the customer measures that will be considered when the company reviews performance. On executive pay, there is a lack of evidence on how the targets will be stretching, weighted towards the delivery of service for customers and how its policies will be applied and monitored. We welcome the company's inclusion of our default gearing outperformance benefits



sharing mechanism.

## 2. Funding to facilitate the development of strategic water resources

We are providing funding to facilitate the development of strategic water resources options for the south and south-east of England to ensure that appropriate regional solutions can be taken forward in future investment plans. We expect companies to set out how they intend to work together to undertake more detailed feasibility and planning work.

£10.3 million of this funding will go to Anglian Water.

## 3. Next steps and overall timeline

Actions for the company are set out in 'Anglian Water: Actions summary table'.

The next part of the process will be the draft determination, followed by the final determination, as set out in the table below.

Date	Milestone
1 April 2019	Revised business plans submitted
18 July 2019	Draft determinations published
30 August 2019	Representations on draft determinations due
11 December 2019	Final determinations published
1 April 2020	Price controls for 2020 – 2025 come into effect

## Appendices

The appendices below can find be found on our [website](#).

- Anglian Water: Test area assessment
- Anglian Water: Test question assessment
- Anglian Water: Actions summary table
  - Anglian Water: Delivering outcomes for customers detailed actions
  - Anglian Water: Accounting for past delivery detailed actions
  - Anglian Water: Securing confidence and assurance detailed actions
  - Anglian Water: Direct procurement for customers detailed actions

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

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