

July 2019

Trust in water

PR19 draft determinations

**Anglian Water – Aligning risk and return
actions and interventions**

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PR19 Draft Determinations: Anglian Water – Aligning risk and return actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company’s response to the action, our assessment of the company’s response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix ‘ANH’ denotes the company Anglian Water. The central acronym references the test area where the action has been identified, please see the ‘PR19 draft determinations: Glossary’ for a key to these acronyms. Actions whose numbers are preceded with an ‘A’ denote required actions and actions whose numbers are preceded with a ‘B’ denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix ‘ANH’ denotes the company Anglian Water. The central acronym references the test area where the action has been identified, please see the ‘PR19 draft determinations: Glossary’ for a key to these acronyms. Intervention numbers are preceded with a ‘C’.

For all other documents related to the Anglian Water draft determination, please see the [draft determinations webpage](#).

Table 1: Anglian Water’s response to required actions and interventions for draft determinations

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
Aligning risk and return	ANH. RR.A1	Required	The company should provide further evidence of how the Board has assured itself that the company remains financeable on its actual capital structure given the statement in the business plan that it does not meet its S&P target.	1 April 2019	<p>Anglian Water has provided a revised Board assurance statement that sets out additional evidence on maintaining actual financeability. The company has also provided a letter of support from its shareholders.</p> <p>Anglian Water has provided evidence in support of balancing and maintaining sufficient headroom for the FFO to net debt ratio and affordability for customers. The company sets out that FFO to net debt ratios are higher than the original business plan</p>	<p>No intervention but further action required.</p> <p>Anglian Water has provided further evidence in support of its target financial ratios. It has also set out that it will reduce gearing with dividends ultimately paid to shareholders restricted in order to achieve this de-gearing – this reduces forecast gearing from 78.5% as at 31 March 2019 to 76.2% over 2020-25 based</p>	Pursuant to action ANH.LR.A5 we require the company to provide Board assurance to confirm how the financeability and financial resilience of the actual structure will be maintained in the context of our draft determination.

					<p>submitted due to further mitigating action undertaken on the debt portfolio, with its financial ratios showing an improving trend. This, along with a commitment to de-gear the business, a narrow range of outcome delivery incentives in the plan, and discussions with S&P, led to the company being confident of maintaining the current credit rating level.</p> <p>The company states rather than increase the RCV run-off rate and therefore increase customer bills, it will continue to use a rate below the "natural" RCV run off rate.</p>	<p>on the assumptions in its plan.</p> <p>However, Anglian Water maintains a high level of gearing under its actual structure. We are not intervening in respect of the financial ratios achieved under Anglian Water's actual financial structure in our draft determinations as it is Anglian Water that is responsible for ensuring it maintains financial resilience and the financeability of its activities over the long term.</p>	
	ANH. RR.A2	Required	The company should provide further evidence to explain why there are positive values for both upside and downside values for Totex (including uncertainty mechanism) or restate its RoRE downside	1 April 2019	<p>Anglian Water provided the following answer: 'As part of our updated data tables we have recalculated RoRE in App26'. The positive/negative signs of the values now accord with our expectations.</p>	<p>No intervention required.</p> <p>Anglian Water has completed the action and the signage convention is now correct.</p>	N/A.
	ANH.RR.B1	Advised	The company should provide further evidence to explain how the RoRE assessment takes account of Anglian Water's systems approach to resilience.	1 April 2019	<p>Anglian Water says the outcomes set out in its business plan were designed and agreed with its customers in order to meet its obligations and improve its resilience both in 2020-25 and beyond. It considers that its RoRE assessment encapsulates the results of its systems approach to resilience.</p>	<p>No intervention required.</p> <p>Anglian Water has satisfactorily completed the action.</p>	N/A.

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
ANH.RR.C1	<p>Anglian Water's approach to setting PAYG rates is to recover operating expenditure including infrastructure renewal expenses included in operating costs. The application of efficient totex in our draft determination has resulted in a change to the mix of opex and capex in totex to the extent that PAYG rates are no longer aligned with Anglian Water's stated approach.</p>	<p>We are making a technical intervention to align PAYG rates to Anglian Water's stated approach of recovering operating expenditure for each year for each wholesale control.</p>
ANH.RR.C2	<p>We are intervening to adjust Anglian Water's risk range for the cost of new debt to 100 bps on the upside and 25 bps on the downside. This is consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt.</p>	<p>We are intervening to reduce Anglian Water's financing risk range associated with the cost of new debt to 100 bps on the upside and 25 bps on the downside. This intervention is consistent with the PR19 methodology. It is also consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt. However, as set out in the Risk and return technical appendix, we are considering the assessment of debt cost risk further for the final determination.</p>
ANH.RR.C3	<p>We assess Anglian Water's C-MeX RoRE range to be wider than the maximum range implied by the cap on retail revenue exposure of +/-12%.</p>	<p>We are intervening to reduce the C-MeX RoRE range to be consistent with the retail revenue exposure cap of +/-12% as set out in section 5 of the company specific appendix.</p>
ANH.RR.C4	<p>We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. This approach seeks to take account of covariance in performance on individual outcome delivery incentives.</p>	<p>We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework.</p>
ANH.RR.C5	<p>We expect companies to update their RoRE risk range analysis in response to the draft determinations.</p>	<p>We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the 'Aligning risk and return technical appendix' that accompanies our draft determination and 'Technical appendix 3: Aligning risk and return' published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the company, taking account of the company's reported level of actual performance delivered in 2015-19 and taking account of the steps it is already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk.</p>

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.

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