

By email to -



Tel 01480 323000
www.anglianwater.co.uk

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Dear Ofwat

Consultation on regulatory reporting for the 2021-22 reporting year

We are pleased to offer our comments on the proposals set out in this consultation. We first of all respond to the proposals of the consultation, including the specific questions, then offer some suggestions of our own about changes to the RAGs that should be considered.

Corrections and clarifications to the 20-21 RAGs

Question 1 What are your views on the proposed changes to the APR tables in A1?2

Table	Line	Issue
4L, 4M	All	<p>Ofwat proposes new columns to capture expenditure versus allowance for each enhancement category.</p> <ul style="list-style-type: none"> - After IAP all spend on growth, flooding and low pressure was assessed under botex plus and Ofwat agreed there was no single way of allocating that allowance between those areas and base capital maintenance. Therefore, we do not know what our total allowances were for growth, flooding or low pressure. - After IAP all enhancement models were converted to totex allowances and therefore the best we can do is to 'assume' capex allowances using the same splits of capex to opex that we included in our plan. - No model outputs were ever profiled over the 5 years of the AMP, they were provided as a single totex figure for 5 years

Green Recovery

When Ofwat made its PR19 final determination for us in December 2019 there were a number of schemes within the WINEP programme that were yet to be confirmed ('amber' schemes). Our FD totex allowance included an allowance for each these schemes and Ofwat included an adjustment mechanism such that the allowance could be recovered at PR24 for every scheme which was not confirmed. In other words, the default assumption was that all these amber schemes would be delivered.



Registered Office
Anglian Water Services Ltd
Lancaster House, Lancaster Way,
Ermine Business Park, Huntingdon,
Cambridgeshire. PE29 6XU
Registered in England
No. 2366656.

an AWG Company

The effect of the green recovery initiative for us was to confirm all of those amber WINEP schemes. Since the green recovery decision has merely confirmed the outcome which had already been assumed, and the costs of them have already been included in the PR19 totex allowance, we assume there is no need to report the costs of these former amber schemes separately in new tables 4S and 4T or the delivery of them in 10B and 10C. There is certainly no rationale for providing scheme-specific costs for these ex-amber schemes when there is no requirement to do likewise for the schemes which were already confirmed in December 2019.

In contrast, our performance commitment 1.2.12, 'Water Industry National Environment Programme', excludes these amber schemes. We suggest that the performance commitment be amended *ex ante* to remove this exclusion so that the ex-amber schemes are now treated in the same way as the rest of the programme. The PC parameters (PCLs, cap, collar, etc.) will need to be re-calibrated to reflect the extension of the programme.

We also have a bespoke, non-financial performance commitment, 1.2.20, 'Delivery of Water Industry National Environment Programme requirements'. Our assessment is that no changes are required to this PC.

Operational greenhouse gas emissions reporting

Question 2 Do you have any other comments or views on the proposal for mandatory standardised reporting for operational GHG emissions, beyond those included in responses to last year's RAGs consultation?

We would recommend being explicit in Table 2 operational carbon that gross emissions are reported under location-based grid factors and net emissions are reported under market-based grid factors. This approach would be in line with the Water UK net zero roadmap and provide clarity on reporting requirements.

Question 3 Are there any other data, metrics or further breakdown or categorisation that should be included in Table 2?

Having considered energy management over many years, we conclude that the most appropriate metric to compare site performance is kWh/MI/m lift. Based on research conducted through the Water UK Energy Managers Forum over ten years ago, a comparison was made of different company treatment works from simple boreholes to surface water treatment works. The principles of the approach in measuring pumped head allowed for a consistent approach grounded in the laws of thermodynamics. This approach could easily be translated though to carbon as kg CO₂e/MI/m lift.

Embedded greenhouse gas emissions reporting

Question 4 What are the key challenges that need to be considered and addressed to facilitate greater standardisation of reporting on embedded emissions?

In 2008 and 2012, there was excellent collaboration across the value chain with the creation of 'A framework for accounting for embodied carbon assets in water industry assets' (UKWIR Reference: - 12/CL/01/15). This, and the predecessor document launched in 2008, forms the basis of the capital carbon approach that we follow today. The challenge is to raise awareness of these documents as the starting point for the sector to review, update and apply for standardisation of reporting. This process has already commenced.

Reducing capital carbon relies on collaboration and the development of opportunities via the value chain. Requiring all parties to apply the PAS2080 Carbon Management in Infrastructure framework will achieve consistency both among companies and the supply chain for measurement and reporting.

Question 5 Are there any particularly relevant frameworks or approaches for us and the industry to consider in relation to embedded emissions reporting and reductions? For example, PAS2080?

As stated above, the UKWIR document 12/CL/01/15 and PAS2080 are the two relevant documents that should be applied for reporting and reductions. The PAS2080 framework has now received funding to be updated via the Green Construction Board, Institution of Civil Engineers and BSI. This provides an opportunity for the regulator and sector to influence the next version of this important standard.

Question 6 What area/s of data or other information do you consider we should focus on for voluntary reporting? For example:

- ***Design, construction and/or maintenance activities***
- ***Number and/or size of suppliers***
- ***Project spend and/or value***
- ***Inputs and/or materials***
- ***Specific services***
- ***Number of GHGs reported on by suppliers***

Based on experience over the last 10 years, we would recommend focussing on capital carbon emissions reduced or avoided against a set baseline as a percentage or absolute value in tonnes of carbon equivalent. We would suggest confirmation that the approach covers a significant proportion of the capital investment portfolio and a breakdown into category areas as listed on the table above.

P removal (new proforma 7F)

We assume from draft RAG 4.10 that we are to report costs on every scheme every year but this could be made clearer.

It is important to note that capital costs do not stop in the year when the scheme is delivered. There is a 'tail' of expenditure for most schemes after delivery to pay for things such as landscaping, fencing, site breakdown, snagging and compensation. This is particularly relevant for schemes delivering late in the AMP; their total capital costs will not be captured in a table that finishes in 2024/25.

A related issue is that companies will only start to incur additional opex in the year of delivery or the following year.

A consequence of the previous two points is that we are likely to produce a set of data that is remotely complete only for those schemes which are delivered in the first year or two of the price control period. These schemes will not necessarily be representative of companies' programmes as a whole. A solution to this issue needs to be found if the information in this table is to be useful at PR24.

To facilitate comparison with the WINEP and avoiding confusion from schemes having multiple names, we suggest adding a column to capture the WINEP unique reference at the same time as the scheme name.

We foresee a problem if the objective is to compare actual and allowed costs at a scheme level: we weren't given an allowance per scheme, we were given the output of a model. The P removal model allowed totex for the programme based on the size of the works, the tightness of the consent and the number of projects in the programme. In order to calculate the allowance for each individual project we would have to run each of our 180 P removal schemes through the model individually and then pro-rate the answer to the programme level allowance.

We do not have suggestions of further cost drivers and welcome the proposals to allow scheme-specific commentary.

Leakage (new proforma 6E)

We applaud Ofwat's intention to develop a richer information base on the costs of leakage control. The determination of leakage costs at PR19 was hampered by the absence of such a dataset and it is right that the industry should start to collect more data now.

We agree that it will be a challenge to produce consistent reporting. We have suggested that Ofwat might wish to work with the WaterUK leakage network to work up some more detailed guidelines. Another way to achieve consistency is to require companies to expose the assumptions they have used in allocating costs, similar to their accounting methodology statements. Comparison of completed returns is also likely to be useful to identify outliers. Through repeated cycles of reporting and analysis it should be possible to work towards a common approach. We are keen to play an active role in this task.

WRMP delivery (new proforma 6F)

On WRMP, we already report outturn benefits in the WRMP Annual Review, so the addition here is costs. Reporting the costs of supply-side schemes is more straightforward but we need to have clarity about the allocation of overheads. For the non-leakage demand options (smart metering and water efficiency measures) it is difficult to ascribe a benefit; our approach will be to list our assumptions on these as we do at present for WRMP reporting and planning. Confidence scores for these would be lower.

It is vital that the tables on both Leakage and WRMP are not in the public domain, as is proposed, to avoid undermining the upstream Water Resources market.

Analysis of debt (proforma 4B)

The additional qualitative information proposed for table 4B will need clearer definition in the RAGs as to what is required. In particular, we need clarity on what is meant by issue price for column 10.

The proposed quantitative information in columns 25 and 26 appear to be format-related changes mostly as the information was already included in the 2020-21 APR 4B already.

The additional quantitative information proposed in columns 10 and 13 can be populated but, once again, we have to reiterate the burden of completing this table every year (over 150 lines in APR21). The consultation document does not explain why this information is required or what use will be made of it. It is good practice for proposals for additional information requirements to be justified, particularly when they incur substantial regulatory burden and cost in companies.

Bioresources

We will respond to the consultations on energy accounting and overheads allocation in August.

Business rates

Question 7 Should the guidance for business rates allocation for the water service be changed in RAG2? If so then what is the most suitable driver?

The consultation does not set out why GMEAV is the wrong driver for allocating rates costs nor what problems would be solved by moving to an alternative. We do not track profit or returns on a price control basis so moving to this basis would create additional work for us with no obvious benefit. Given this, we see no reason to move from the current approach.

Jointly owned assets

Question 8 Does your company jointly own or operate assets with another company? Should guidance be included in this area? What specific points should the guidance cover?

The only asset we own or operate jointly currently is Ardleigh reservoir, which we jointly own with Affinity Water. We have not identified the need for any additional guidance on how to account for the costs of this.

Other suggested changes to the RAGs

The RAG consultation was published during the time when companies were completing their 2021 APRs and raising queries. These queries, and Ofwat’s responses to them, were gathered in the APR query log. Our analysis of the last version of the query log identifies over a hundred queries where the response suggests a change to the RAGs or tables is required or where additional clarity could helpfully be added to the RAGs. We recommend that all these comments should be captured by hard-wiring them into the RAGs. (We acknowledge some may already have been captured in the table at appendix 4 of the consultation document.) If the learning from APR21 is captured in this way, the query log for APR 2022 should be substantially smaller.

In addition to the queries we raised during the APR process we have also noted the issues set out in the following table:

Table	Line	Issue
3F	9	RAG 4.09 states that the figure in column 23 should be copied from 4F.19. However, the figure in 4F.19 relates only to water customers and the denominator should include waste water customers also. Voids should be excluded. The query log acknowledged that the definition should be amended.

		Going further, though, we think it would make sense to include lines in table 4F to report waste water customers billed at year end to match the block for water customers. 3F.9 could then refer to the relevant cells in 4R.
4L	70+	In APR 21 we used the freeform lines at the end of table 4L to report our expenditure on smart metering. Given the sums here for ourselves and others will be substantial in AMP7 we question whether permanent lines should be established in the metering block.
3F	7	The row heading is 'number of properties' but should be 'number of properties (thousands)'
2A	4, 8	The impact of prime use recharges does not make sense unless retail is removed from 2A.8.
4E, K, M	All	We continue to question the value of allocating costs between foul sewer, surface drains and highway drains and the purpose to which this information is put. The basis for the allocation is not sufficiently robust to make these estimates of any value.

During the APR 21 process companies were asked to unlock and overwrite various cells in the tables, in particular in App1, the ODI model. To avoid having to re-do this at APR22, we request that Ofwat captures these changes in the tables it issues for next year. In addition, the model should reflect adjustments made by the CMA re-determination and our IDOK.

Use of table 1F for calculating Returns on Regulated Equity (RORE)

Background and issue

RORE calculates the returns on a regulatory basis by reference to the notional gearing level (historically 62.5%, now 60%) and average RCV for the year.

The main benefit of RORE is that provides stakeholders a way of comparing returns across the industry but also stakeholders in other regulated sectors such as energy for companies with different gearing. It is used by regulators and also by investors looking to compare companies' performance.

In AMP 7 the RORE calculation has been removed and linked to the Financial Flows middle column. The calculation now adjusts the base return depending on the gearing of the company, removing the ability to compare companies.

Differences in the calculation

For many years, RORE has been calculated in a set way, being the base RORE set at the determination and then adjusted by performance factors, both financial and operational. However, in 2018, in response to Ofwat's challenge on 'high' gearing in the sector, companies were asked to produce, for the first time, the Financial Flows of the business.

In addition to the elements included in RORE, the Financial Flows introduces a number of different concepts, in particular a theoretical gearing adjustment applicable to companies whose gearing is different to the notional company which, all things being equal, will be offset by an increase in cost of debt associated with higher gearing (Modigliani Miller theorem).

The model also introduces an out/(under) performance on tax compared to that allowed in the FD and shows operational performance pre-tax as a result.

Key issue

The Financial Flows table not only shows the notional return as a percentage of notional equity (essentially the equity return set at FD) compared to the actual return as a percentage of actual equity (being an approximation of the return equity investors are earning), the table also includes a middle column called “actual return as a percentage of notional equity”.

This is a mathematical calculation which takes the £m actual return/performance as a percentage of notional equity (40% * RCV).

The issue is that, for companies with gearing above 60%, the calculation reduces the base return. The opposite occurs for companies with gearing below 60%.

As all that has happened at this point is an adjustment for gearing, we would at least expect the following ‘gearing’ row to bring the number back to the base return. However, it does not.

Below is an illustration of the issue. It compares the funding companies receive to the cost to the company and assumes the profit is the return to the shareholders. It assumes no out/under performance:

RCV	10,000
Notional gearing	60%
Actual gearing	80%
Equity return	4.33%
Cost of debt	2.50%

Gearing calculation

$$(Actual\ Gearing - Notional\ Gearing) * (Equity\ Return - Cost\ of\ Debt\ allowed) * RCV = (80\% - 60\%) * (4.33\% - 2.50\%) * 10,000$$

FD notional company

	Revenue	Cost	Profit
Opex (PAYG)	650	-650	0
RCV run off	300	-300	0
Cost of debt	150	-150	0
Cost of equity	173.2	0	173.2
	<u>1273.2</u>	<u>-1100</u>	<u>173.2</u>

Notional equity 4,000

FF table shows this as

Base return	173.2	4.33%
Gearing benefit	0	0.00%

RORE (assuming no performance)	173.2	4.33%
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Actual (80% geared but no out/under performance)

	Revenue	Cost	Profit
Opex (PAYG)	650	-650	0
RCV run off	300	-300	0
Cost of debt	150	-200	-50
Cost of equity	173.2	0	173.2
	1273.2	-1150	123.2

Actual equity 2,000

FF table shows this as

Base return	86.6	4.33%
Gearing benefit	36.6	1.83%
RORE (assuming no performance)	123.2	6.16%

Impact on Actual RORE (notional equity of 4,000 as denominator)

Base return	86.6	2.17%
Gearing benefit	36.6	0.92%
	123.2	3.08%

As illustrated, the starting position for RORE is now 3.08% not 4.33%. This means that when comparing returns across sectors it starts from a point that is non-comparable. The reality is that, before considering the impact on cost of debt, investors benefit from replacing more expensive equity with cheaper debt; the calculation, however, shows a negative impact|

Yours sincerely,


Alex Plant
Director of Strategy and Regulation