

August 2021

# **Final Determination of Anglian Water's interim determination application**

**Ofwat**

## About this document

This document sets out our final determination on Anglian Water Services Limited's ('Anglian Water') application for an interim adjustment to the level of price controls ("interim determination") in the 2020-2025 price control period in relation to its Direct Procurement for Customers (DPC) project. It also confirms a consequential change to one of Anglian Water's performance commitments.

In making our decisions, we want to be as transparent as we can with all stakeholders about how we have reached them. This document sets out the vast majority of the information we based our decision on.

Unless otherwise stated, all figures in the summary of this document are based on the 2017-18 price base and are consistent with the price base used in our 2019 price review (PR19) final determination of Price Controls for 2020-25 and the CMA's redetermination.

## Contents

1. Summary	3
2. Background	6
3. Stakeholders' responses to our draft determination	9
4. Our final assessment and what we have allowed in our final determination	11
5. Performance Commitment	13
A1 Assumptions within our final determination	14

# 1. Summary

## 1.1 Anglian Water's application and our draft determination

On 22 June this year, Anglian Water asked us to increase the level of the price controls that were determined for the period 2020–2025. Under the conditions of its appointment (“licence”), Anglian Water can ask us to increase the level of price controls where (among other things) there is a material change to the scope of a project that the company is required to put out to tender under the DPC process and the changes in costs are material. The materiality threshold that applies for an interim determination in relation to a DPC project is a change in costs with a net present value (“NPV”) equivalent to the lesser of £10m or 2% of appointed business turnover (referred to as a relevant effect in the licence).

Anglian Water's application asked us to increase charges to customers to allow it deliver two components of its DPC project, the Elsham Transfer and Treatment scheme, in-house instead of including them in the tender for the DPC project. Anglian Water:

- requested £87.9m to deliver a large transfer pipeline and conditioning plant in-house.
- proposed a reduction to the DPC costs we allowed at PR19 to design the scheme and develop it for competitive tender – it proposed to return £4.4m opex to reflect that a smaller scheme would be delivered via DPC.

Alongside its application to amend price controls, Anglian Water:

- proposed to mitigate the potential loss of customer benefit, due to no longer delivering the full scheme through DPC, by committing to invest an additional £1.4m in lead pipe replacement and undertook to replace pipes in at least a further 280 properties – this will be wholly funded by the company's shareholders and is outside of its totex allowance for 2020–2025.
- requested that we amend its internal interconnection delivery performance commitment (PR19ANH\_39), as a consequence of the interim determination, to include the transfer pipeline and conditioning plant elements of the DPC project which will now be delivered in-house.

Further information on Anglian Water's application is available in our [draft determination document](#).

Under the licence, Ofwat is expected to review requests for interim determinations and make a determination within three months of receiving the application. On 30 June 2021, we published our draft determination on Anglian Water's application and we concluded that the majority of its requested costs within the application were appropriate and efficient, and in total exceeded the materiality threshold for interim determinations in relation to a DPC project. We, therefore, proposed to accept the majority of Anglian Water's application and

proposed a small challenge in relation to the value of the DPC costs that the company should return to customers. In reaching our draft determination, we took into account Anglian Water’s proposal to fund at its shareholders’ expense additional investment in lead pipe replacement.

The table below summarises the company’s and our assessment of the interim determination application

**Table 1: Summary of draft determination**

(£m, 2017-18 price base)	Company’s assessment	Our Assessment
Estimated net change in capital expenditure over period 2020-25	87.667	87.667
Estimated net change in operating expenditure over period 2020-25	-4.133	-4.333
Relevant effect (NPV of total net change in costs must equal or exceed the lesser of £10m or 2% of turnover)	£78.8m (or equivalent to 6% of turnover)	£78.6m (or equivalent to 6% of turnover)

With regard to Anglian Water’s proposal to amend its performance commitment, while amendments to performance commitments are outside the interim determination, we consulted on the proposed change in our draft determination.

We invited interested parties, including Anglian Water, to comment on our draft determination.

## 1.2 Our approach to the final determination

We have made our final determination under paragraph 15A of Condition B: Charges of Anglian Water’s licence in accordance with our statutory duties and the [UK Government's statement of strategic priorities and objectives for Ofwat](#). Our statutory duties<sup>1</sup> require us (in summary) to set price controls in the manner we consider is best calculated to:

- further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that water companies properly carry out their functions;
- secure that the companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and

<sup>1</sup> The general statutory duties for most of our work as an economic regulator are set out in section 2 of the Water Industry Act 1991.

- further the resilience objective to secure the long-term resilience of companies’ systems and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.

Subject to those duties, we also have duties to (among other things) promote economy and efficiency and contribute to the achievement of sustainable development.

In making our final determination, we considered all the evidence available to us – including the information provided to us in Anglian Water’s application and the responses to our draft determination.

We received three responses to our draft determination, including Anglian Water, who accepted our draft determination. We have published all the responses on our website today and respond to stakeholders’ substantive points in section 3.

### 1.3 Our view of the final determination

Our final determination is in line with our draft determination and we have not made any changes following responses from stakeholders, with the exception of updating the materiality assessment with Anglian Water’s 2020-21 appointed business turnover from its latest published accounts which it published in July 2021. The update has only a minor impact on our materiality assessment (the size of the relevant effect) and the company’s application and our view of allowed costs continues to pass the materiality threshold.

The table below summarises our final determination and shows that we continue to apply a £0.2m challenge to Anglian Water’s DPC development costs.

**Table 2: Summary of final determination**

(£m, 2017-18 price base)	Company’s application	Final Determination
Estimated net change in capital expenditure over period 2020-25	87.667	87.667
Estimated net change in operating expenditure over period 2020-25	-4.133	-4.333
Relevant effect (NPV of total net change in costs must equal or exceed the lesser of £10m or 2% of turnover)	£78.8m (or equivalent to 6.6% of turnover)	£78.6m (or equivalent to 6.5% of turnover)

## 2. Background

This document explains our assessment of Anglian Water's application for an interim determination of price limits, sets out our final determination (which confirms our draft determination) and sets out the reasons for our decision. This section summarises:

- whether Anglian Water's application meets the requirements for an interim determination;
- what is in Anglian Water's application; and
- our draft determination of Anglian Water's application.

### 2.1 Whether Anglian Water's application meets the requirements for an interim determination

Condition B of Anglian Water's licence allows the company to apply to us for a change to the level of one or more of its price controls (an interim determination) in specific circumstances. In relation to DPC Delivered Projects, Condition B allows changes to the level of price controls to be made if one or more specified DPC Events has occurred and the total net material impact on the company, in present value terms, equals or exceeds the lesser of £10m or 2% of the turnover of the company's appointed business turnover. A "DPC Event" includes, amongst other things, where a designation of a DPC Project has been modified or revoked by Ofwat under licence condition U.

Our draft determination concluded that Anglian Water's application did meet the requirements of its licence. As there have been no changes between the final determination and draft determination, we confirm our assessment after updating our assessment of materiality with the latest turnover figure published in Anglian Water's 2020-21 accounts. See table 2 for the updated assessment.

### 2.2 What is in Anglian Water's application?

Anglian Water requested funding for two components of its Elsham Transfer and Treatment scheme, which it will now deliver in-house rather than via DPC following our modification of the designation of the DPC project. It is requesting additional totex of £83.534m to deliver.

As the scheme was to be delivered by DPC, in PR19 we did not provide for an allowance for the company to deliver the scheme itself, but rather required Anglian Water to put the scheme out to competitive tender for a third party to design, build, finance, operate and maintain the scheme. We instead allowed £9.4m for Anglian Water to design the project and to put it out to tender.

Following our final determinations in December 2019, Anglian Water said that it considered delivery of the full scheme by DPC would not allow it to meet its statutory environmental obligations by March 2025 and it asked that it be permitted to deliver the transfer pipe and conditioning plant components of the project in-house. After discussions with the Environment Agency and Anglian Water, we agreed to this request.

Consequently we modified the DPC designation of the Elsham scheme, removing the conditioning plant and transfer pipeline elements, leaving only the water treatment works to be delivered by DPC. The modification of the designation was a DPC Event (as defined in Condition B) and allowed Anglian Water to bring an application for an interim determination.

The table below summarises the net additional costs in Anglian Water's interim determination application:

**Table 3: Proposed net additional totex**

Net additional costs (£m) (2017-18 prices)	2020/21	2021/22	2022/23	2023/24	2024/25	AMP 7 Total
Capex	0	4.424	26.397	43.774	13.072	87.667
Opex	0	(4.353)	0	0	0.220	-4.133
<b>Totex</b>	<b>0</b>	<b>0.071</b>	<b>26.397</b>	<b>43.774</b>	<b>13.292</b>	<b>83.534</b>

Anglian Water's interim determination application would result in an increase to customer bills of £0.84 by the end of AMP7, and Anglian Water estimates this to be less than 0.25% increase on the total bill for an average Anglian Water customer. The table below shows the impact of the interim determination application on customer bills over AMP7.

**Table 4: Proposed customer bill impacts**

	2020/21	2021/22	2022/23	2023/24	2024/25
<b>Customer bill impact (£)</b>	-	0.00	0.36	0.71	0.84

Alongside its application to amend price controls, Anglian Water proposed to mitigate the potential loss of customer benefit, due to no longer delivering the full scheme through DPC, by committing to invest an additional £1.4m in lead pipe replacement and undertook to replace pipes in at least a further 280 properties – this will be wholly funded by the company's shareholders and is outside of its totex allowance for 2020-2025. While the proposal is outside the scope of the interim determination, we took this proposal into account when we assessed Anglian Water's application and issued our draft determination. Anglian Water will report its progress against this commitment and has committed to share with us detailed information on the cost of delivery.

## 2.3 Our draft determination

We briefly recap our approach to the draft determination. Further detail on our approach to interim determinations related to DPC projects and our approach to the draft determination can be found in the [draft determination](#).

### Costs

Our review of Anglian Water's proposed cost to deliver the transfer pipeline and conditioning plant concluded that the costs were efficient.

Partially off-setting the additional totex requirement for the conditioning plant and transfer pipeline, Anglian Water proposed to return £4.4m to customers. This amount was part of the £9.4m of DPC costs we allowed at PR19 to develop the project, and which covered design costs, pre-tender costs, tender costs, and contract management costs.

The £4.4m Anglian Water proposed to return related to design costs. We agreed that it was appropriate to return this money to customers and we also considered whether allowed DPC costs should be further reduced to reflect that the company would now be procuring a smaller, less complex scheme. As a result our draft determination included a challenge of £0.2m to tender costs.

### Approach to calculating allowed revenue and decision on the appropriate rate of return

In relation to DPC projects, Condition B does not prescribe how the change in the level of price controls should be calculated. For Anglian Water's interim determination application, as the transfer pipeline and conditioning plant would have been included as part of the PR19 final determination had they not been identified as part of a DPC project, we concluded that it was appropriate to calculate any change to the level of price controls in line with the approach to calculating allowed revenues at PR19 and the CMA redetermination. Additionally, we considered that as the CMA could have chosen to include the costs in its re-determination, the appropriate rate of return to use was the cost of capital re-determined by the CMA earlier this year. Therefore, for the draft determination, we used the wholesale allowed return on capital of 3.12% ('Vanilla' weighted average cost of capital).

### 3. Stakeholders' responses to our draft determination

We received three responses to our draft determination from:

- Anglian Water
- Consumer Council for Water (CCWater)
- United Utilities.

We have published all the responses on our website today and respond to stakeholders' substantive points below. Anglian Water accepted our draft determination without any further representations.

#### CCWater

CCWater agreed that where a project no longer proceeds via DPC, companies should look to mitigate the potential loss of customer value. Where companies do not offer any form of mitigation, CCWater suggested that we should return the value to customers at a future date (if we are unable to take account of this in an interim determination process). Any proposed form of mitigation should be underpinned by evidence of customer support and CCWater noted they were unclear as to the support for Anglian Water's proposed investment in lead pipe replacement.

We agree with CCWater that where a DPC project (in full or part) no longer proceeds via DPC, companies should mitigate the potential loss of value to customers. With regard to customer support for Anglian Water's proposal to mitigate the potential foregone benefits, the company has provided us with evidence from PR19 demonstrating that investment in lead pipe replacement directly relates to providing customers with safe, clean water, which is a priority for its customers. Given the proximity to PR19, Anglian Water has not carried out additional customer engagement on its proposed investment.

#### United Utilities

United Utilities' response focussed on the appropriate rate of return to apply in the case of interim determinations. While United Utilities were supportive of our proposal to use the weighted average cost of capital from the CMA's recent re-determination of Anglian Water's 2020-2025 price controls for the interim determination, it raised the following concerns:

- The potential for the cost of debt to be used instead of the cost of capital, and that it considered applying the cost of debt would be inappropriate in all circumstances.
- The potential for inconsistent treatment if multiple companies were to apply for an interim determination at the same time, where some of the companies had appealed the PR19 final determination and others had not.

On the potential use of the cost of debt rather than the weighted average cost of capital, in a “standard” interim determination the appropriate rate of return is specified by the terms of companies’ licences. At present, there is variation between companies’ licences in this area and some licences require us to use the cost of capital and others require us to use the cost of debt. This was a choice made by companies in the late 1990s. Therefore, in future interim determinations we may be required to use the cost of debt.

For interim determinations relating to DPC projects, the licence does not specify what rate of return we should use and only specifies what discount rate we should use for the purpose of determining whether the DPC Event has or will have a relevant effect on the appointed business – the materiality threshold. For Anglian Water’s interim determination, this meant we were required to use the cost of debt to assess materiality, but were able to consider what the appropriate rate of return should be based on the specific circumstances of Anglian Water’s application. For this interim determination, we decided the CMA’s weighted average cost of capital was appropriate because the CMA could have chosen to include the costs in its recent re-determination. This is a decision specific to the circumstances of this interim determination and the Elsham Transfer & Treatment scheme. It does not mean that we would necessarily use the CMA’s weighted average cost of capital in a future interim determination (DPC related or otherwise) for Anglian Water or any other water company. In deciding the appropriate rate of return to use for an interim determination, we will consider the specific circumstances of a company’s interim determination application at the time, subject to the provisions of the company’s licence.

## 4. Our final assessment and what we have allowed in our final determination

We have reviewed stakeholders' responses to our draft determination and have concluded no changes to our draft determinations are required, and we re-confirm that:

- the modification of the DPC designation of the Elsham Transfer & Treatment scheme meets the definition of a DPC Event under condition B of Anglian Water's licence and it qualifies for an interim determination;
- the costs Anglian Water has requested are a consequence of the DPC Event and are efficient with the exception of the tender costs where we have included a challenge of £0.2m; and
- our assessment of efficient costs means that the DPC Event will have a relevant effect on the appointed business (in other words, it exceeds the materiality threshold).

We have, therefore, accepted Anglian Water's proposed change subject to our challenge on DPC tender costs. The tables below confirm our decision on additional costs, allowed revenue, the change to the level of the price control for Network Plus Water Activities and bill impacts.

**Table 5: Our view of net additional costs compared to Anglian Water's application**

Net additional costs (£m) (2017-18 prices)	2020/21	2021/22	2022/23	2023/24	2024/25	AMP 7 Total
<b>Company view</b>	0	0.071	26.397	43.774	13.292	83.534
<b>Our view</b>	0	0.071	26.197	43.774	13.292	83.334
<b>Difference</b>	0	0	-0.200	0	0	-0.200

**Table 6: Water Network Plus Allowed Revenue**

(£m, Real)	2020-21	2021-22	2022-23	2023-24	2024-25	Total
<b>CMA redetermination</b>	408.168	421.002	440.976	461.100	482.046	2,213.292
<b>Interim determination FD</b>	408.168	421.002	441.938	463.024	484.300	2,218.432
<b>Change</b>			0.962	1.924	2.254	5.140

**Table 7: Change in average combined bill**

(£, Real)	2020-21	2021-22	2022-23	2023-24	2024-25
<b>CMA redetermination</b>	394.06	387.60	396.87	404.73	415.49
<b>Interim determination FD</b>	394.06	387.60	397.21	405.42	416.28
<b>Change</b>			0.34	0.69	0.79

We note, that regardless of the interim determination, customers would have faced an increase in the level of their bills for the delivery of the whole project via DPC.

Having decided that the level of the Price Control for Network Plus Water Activities should be changed, we therefore determine that the "K" numbers for each relevant Charging Year are those set out in Table 8 in the "Interim determination FD" row.

**Table 8: Change in K numbers for each charging year**

Percentage change	2020-21	2021-22	2022-23	2023-24	2024-25
<b>CMA redetermination</b>	0.00%	3.22%	4.92%	4.67%	4.64%
<b>Interim determination FD</b>	0.00%	3.22%	5.16%	4.88%	4.70%
<b>Change</b>			0.24%	0.22%	0.07%

## 5. Performance Commitment

Alongside its application for an interim determination, Anglian Water also requested that we amend its internal interconnection delivery performance commitment (PR19ANH\_39), as a consequence of the interim determination, to include the transfer pipeline and conditioning plant elements of the DPC project which will now be delivered in-house. This performance commitment incentivises the company to ensure that customers in its region have sufficient water in the future and holds Anglian Water to the delivery of additional capacity by the end of AMP7. Where Anglian Water does not deliver the performance commitment level, we can recover allowed costs through underperformance payments at the end of AMP7.

Changing a performance commitment does not constitute a change in price controls and therefore amending performance commitments does not fall within the scope of an interim determination. While the amendment to the performance commitment is outside the interim determination, we consulted on the proposed change as part of the draft determination, where we proposed to accept the company's proposal as we agreed it was appropriate to amend the commitment in order to protect customers' interests should the company fail to deliver the transfer pipeline and conditioning plant.

The responses we received to our draft determination did not comment on the proposed change to the performance commitment. We have, therefore, accepted Anglian Water's proposal to amend its internal interconnection delivery performance commitment (PR19ANH\_39). The table below summarises the amendment and we will publish an updated change log for Anglian Water on our [website](#) later this year when we publish other changes to performance commitments as a result of the CMA re-determination.

**Table 9: Proposed change to Anglian Water's 'Internal interconnection delivery' performance commitment**

	Current	Amendment
<b>Performance commitment by 2024-25 (MI/d)</b>	382.4	469.4
<b>Underperformance rate (£m per MI/d)</b>	0.460	0.459
<b>Other changes</b>		Insert transfer pipeline and conditioning plant schemes into table in performance commitment that lists schemes and capacity benefit

## A1 Assumptions within our final determination

This final determination relies on the following assumptions:

### Discount rate

In order to determine the NPV of each item for the materiality tests, we need to apply a discount rate. Depending on the individual licence of the company, condition B states that the rate used in the assessment of materiality should reflect either the cost of debt or the weighted average cost of capital. Anglian Water's licence requires us to use the cost of debt.

For our assessment of materiality in the final determination, we have assumed the pre-tax cost of debt determined by the CMA in its recent redetermination of Anglian Water's price controls. Given the introduction of the new cost of debt reconciliation mechanism at PR19, we also considered whether the cost of debt should be indexed. However as the interim determination application has been made in the first year of the AMP and Anglian Water's claim easily meets the materiality threshold, indexing the cost of debt will not have a material effect on the outcome of Anglian Water's application. We have, therefore, used the CMA's pre-tax cost of debt (2.18%) as set out in its redetermination.

Note, in relation to DPC Delivered Projects, Condition B does not prescribe how the change in level of price controls should be calculated. For our final determination, we have assessed allowed revenues using the weighted average cost of capital for the wholesale price controls as set out in the CMA's redetermination. We have taken this approach as the CMA could have chosen to include the costs in its re-determination. This is a decision specific to the circumstances of this interim determination and the Elsham Transfer & Treatment scheme

### Appointed business turnover

Calculations for determining materiality tests require that we use the lesser of £10m or 2% of the company's appointed turnover as last reported to us. For the final determination, this means we use the 2020-21 appointed business turnover of £1,200.9m (2017/18 prices).

### Impact on cost sharing

At PR19, we included cost sharing mechanisms to require companies to share any over or underspend of its cost allowance with its customers. In line with our approach to setting price controls at PR19 and the CMA's approach to its redetermination of Anglian Water's price controls, any increase in price controls as a result of the interim determination will be reflected in allowed costs for the purposes of calculating any over- or underspend. This does not affect the cost sharing rates set by the CMA as part of its redetermination.

**Ofwat (The Water Services Regulation Authority)  
is a non-ministerial government department.  
We regulate the water sector in England and Wales.**

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA  
Phone: 0121 644 7500

© Crown copyright 2021

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit [nationalarchives.gov.uk/doc/open-government-licence/version/3](https://nationalarchives.gov.uk/doc/open-government-licence/version/3).

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at [www.ofwat.gov.uk](https://www.ofwat.gov.uk).

Any enquiries regarding this publication should be sent to [mailbox@ofwat.gov.uk](mailto:mailbox@ofwat.gov.uk).

**OGL**