

June 2021

Draft Determination of Anglian Water's interim determination application

About this document

This document sets out our draft determination on Anglian Water Services Limited's ('Anglian Water') application for an interim adjustment to the level of price controls ("interim determination") in AMP7 in relation to its Direct Procurement for Customers (DPC) project. It also sets out a consequential proposed change to one of Anglian Water's performance commitments. We welcome views of all stakeholders on our draft determination and the consequential proposed change to a related performance commitment. We will consider consultation responses before making our final determination in July and before changing the performance commitment.

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. However, in a small number of instances information directly relevant to our draft determination may be commercially sensitive for Anglian Water. In these instances we have excluded the information from the public version of this document.

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 Final Determination of Price Limits for 2020-25 (PR19) and the CMA's redetermination.

Responding to this consultation

In order to meet our timetable for the final determination of Anglian Water's application, we ask that comments and representations are sent to **Kate Kendall** (email: DPC@ofwat.gov.uk) by close of business on **7 July 2021**.

To ensure transparency, we expect companies to publish their representations in full. We also intend to publish all the written representations we receive on our website at www.ofwat.gov.uk once our final determinations are made.

Unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our [privacy policy](#).

If you would like the information that you provide to be treated as confidential, please be aware that under the FoIA there is a statutory [Code of practice](#) which deals, among other things, with obligations of confidence. In view of this, respondents should identify the information that is considered confidential and explain why. We would expect strong, robust reasons that are specific to the information concerned. We will take such explanations into

account, but we cannot give an assurance that information included in representations will not be disclosed. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Where Anglian Water or other interested parties are making representations, they should consider what further evidence may be necessary to submit with their representations as a result of this draft determination. Where the company considers that we have not appropriately considered any points previously raised by it, it should include this within its representations.

Contents

1. Summary	4
2. Background	6
3. Assessment of Anglian Water's costs and other consequential changes	12
4. Conclusions	18
A1 Assumptions within our draft determination	19

1. Summary

1.1 Anglian Water's application

On 22 June this year, Anglian Water asked us to increase the level of the price controls that the CMA 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.

At the 2019 Price Review (PR19), Anglian Water requested funding for the Elsham Transfer and Treatment scheme, which will comprise of a large transfer pipe, a conditioning plant, and a water treatment works (including storage reservoirs). Anglian Water requires the scheme to enable it to:

- Ensure it is resilient to meet 1 in 200 year droughts by March 2025
- Contribute to the alleviation of forecasted supply demand deficits across its region
- Enable it to meet its statutory environmental obligations by March 2025

At PR19, we accepted the need for the scheme and determined that it was suitable to be delivered via DPC. We, therefore, did not provide an allowance for the company to deliver the scheme itself, but rather required the company to put the project 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 put it out to tender under a DPC arrangement.

Following our final determinations for PR19 in December 2019, Anglian Water said that it considered delivery 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 agree there is a material risk of late delivery if delivered via DPC and have, therefore, accepted Anglian Water's request to reduce the scope of the DPC project. On 10 June 2021, we issued a [modified designation notice](#), removing the transfer pipe and conditioning plant from the original description of the scope of the scheme to be delivered via DPC, and published our [reasons](#) for agreeing to the change in scope.

Under condition B of Anglian Water's conditions of Appointment ('licence'), the company can request an interim determination in relation to a DPC project, where we modify a DPC designation. It has, therefore, applied for an interim determination and is requesting additional totex funding of £87.9m to enable it deliver the transfer pipe and conditioning plant components in-house. Anglian Water's application also includes a reduction to the costs we allowed at PR19 to develop the DPC project and the company is proposing to return £4.4m of opex to reflect that it will now deliver a smaller scheme via DPC. In addition, the

company has asked us to make a consequential change to one of its performance commitments in order to recognise that part of the Elsham Transfer and Treatment scheme will be delivered in-house.

1.2 Our review of the application

Having reviewed Anglian Water's application, our initial view is that the majority of its requested costs within the application are appropriate and efficient, and in total exceed the materiality threshold for interim determinations in relation to a DPC project. We are, therefore, proposing to accept the majority of Anglian Water's application and proposing to apply a small challenge in relation to the value of the DPC costs that it should return to customers. 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 lessor of £10m or 2% of turnover)	£78.8m (or equivalent to 6% of turnover)	£78.6m (or equivalent to 6% of turnover)

2. Background

This document explains our assessment of Anglian Water's application for an interim determination of price limits and sets out:

- What is DPC;
- Whether Anglian Water's application meets the requirements for an interim determination;
- What is in Anglian Water's application; and
- Our approach to assessing Anglian Water's application.

At PR19 we introduced DPC in order to introduce competition into the delivery of large infrastructure projects. The approach requires companies to put out to competitive tender large infrastructure projects where delivery by a third party is likely to offer better value for money for customers. A Competitively Appointed Provider ("the CAP") may be appointed to design, build, finance, operate and maintain the relevant infrastructure and a water company will enter into an agreement with a CAP ("a CAP Agreement") to deliver the asset and the relevant services.

In February 2021, we modified five companies' licences to give effect to the DPC delivery model, establishing the framework for the regulation of DPC projects. This allows Ofwat, with the agreement of the water company, to designate a project as a DPC Delivered Project. Once designated, the company is required to deliver the project via DPC. The designation notice sets out the scope of the project that is to be put out to tender.

As DPC projects will be financed by the CAP, we did not make provision in companies' price controls for them to deliver DPC projects themselves. Instead, water companies will be able to recover the CAP charges from customers under an Allowed Revenue Direction that we will issue when a water company enters into a CAP Agreement.

Further information on DPC can be found [here](#)

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

Has a DPC Event occurred and are the items included in Anglian Water's application consistent with the terms of its licence?

Condition B of Anglian Water's licence allows it 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 have 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 company's appointed business turnover.

In summary, a "DPC Event" is any of the following:

- where a DPC procurement process is, for reasons outside the reasonable control of the Appointee, no longer in the best interests of customers;
- where a designation of a DPC project has been modified or revoked by Ofwat under licence condition U;
- where a DPC Allowed Revenue Direction has been revoked by Ofwat under licence condition U; and
- the termination or expiration of an approved CAP Agreement.

For Anglian Water's interim determination application, the relevant DPC Event is the modification of its DPC project's designation notice which reduced the scope of the designated project. We made the notice on 10 June 2021.

Where a DPC Event has occurred, we will only allow costs to be included within an interim determination if they are allowed under the terms of the licence – that is, in the case of a DPC interim determination, the costs are associated with a DPC Event.

What is the appropriate net additional cost attributable to the DPC Event and does the Relevant Effect meet or exceed the materiality threshold set out in the licence?

An important part of our determination is reaching a view on the costs in Anglian Water's application. In particular, we must consider whether the costs in Anglian Water's application are an increase on those costs already allowed in Anglian Water's current price controls; and are efficient. Where we consider additional costs being included in an application to be inefficient or higher than we would expect, we challenge the costs concerned as we do at price reviews more generally.

Condition B of the licence sets a threshold before any changes can be made to the level of Anglian Water's price controls and how to calculate the relevant effect of the application. For an interim determination relating to DPC Delivered Projects, the threshold is a relevant effect on the appointed business that is equal to or greater than the lesser of £10m or 2% of the company's appointed business turnover.

Turnover of the appointed business is determined by reference to the accounting statements for the latest financial year submitted to Ofwat. In the case of this draft determination, this is 2019-20, and the relevant amount is: £1,308.6m. As the costs in Anglian Water's application are in 2017-18 prices, we have deflated the turnover to 2017-18 prices for the purpose of the materiality test. The appointed business turnover in 2017-18 prices is: £1,259.3m.

The relevant effect of Anglian's Water application is £78.8m (calculated as the NPV of total net change in costs) equivalent to 6% of turnover and therefore its application exceeds the materiality threshold for interim determinations in relation to DPC projects.

By the time of the final determination of this application, Anglian Water will have published its 2020/21 regulatory accounts and we will update our materiality test with the latest reported turnover.

2.2 What is in Anglian Water's application?

Anglian Water is requesting 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 £83.5m to deliver these two components.

At the 2019 Price Review (PR19), Anglian Water initially requested funding for the Elsham Transfer and Treatment scheme, which will comprise of:

- A large transfer pipeline from Elsham to Lincoln – enabling Anglian to transfer up to 62Ml/d;
- A conditioning plant; and
- A water treatment works able to treat up to 31Ml/d of raw water.

At PR19, we accepted the need for the scheme and determined that it was suitable to be delivered via DPC. We, therefore, 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.

In January 2020, Anglian Water requested us to refer our PR19 final determination to the Competition and Markets Authority ('CMA') for redetermination. As part of its submissions to the CMA, Anglian Water identified a risk of late delivery of the Elsham Transfer & Treatment scheme, if the entire scheme were required to be delivered by DPC. If the scheme was delivered late, Anglian Water would be at risk of not being able to meet its statutory environmental obligations by March 2025.

Anglian Water requested the CMA to permit it to deliver the transfer pipeline and conditioning plant elements in-house, and include in its allowance an additional totex funding of £87.9m for delivering the two components. The company also proposed a reduction to the DPC costs we allowed at PR19 to design the scheme and develop it for competitive tender, and it proposed to return £4.4m opex to reflect that a smaller scheme would be delivered via DPC.

Ofwat made representations to the CMA in response to Anglian Water's request. We argued that Ofwat had a clear process for dealing with requests to change the scope of DPC projects and to deal with the financial consequences if we did agree to descope a project. The CMA agreed with us that given the separate process in place to consider the issue, it would be inappropriate for it to intervene in relation to the scope of the DPC project.

We subsequently agreed with Anglian Water's request to deliver the conditioning plant and transfer pipeline in-house.

We have 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 allows Anglian Water to bring this application for an interim determination.

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

Table 2: 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
Totex	0	0.071	26.397	43.774	13.292	83.534

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 on customer bills over AMP7.

Table 3: Proposed customer bill impacts

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

We note that delivering the descope elements of the project under DPC would have resulted in an increase in customer bills in the future, albeit we would have expected it to be lower as a result of the benefits DPC can deliver for customers. Additionally the profile for bill increases would have differed if the project had been delivered fully by DPC as customers would not have started to see an impact on their bills until the assets were operational.

To address the differential in customer value, Anglian Water's application proposes to increase its investment in lead pipe replacement in AMP7 compared to the funding it received at PR19. It is proposing to invest an additional £1.4m in lead pipe replacement and

undertakes to replace pipes in at least a further 280 properties. This would be wholly funded by the company's shareholders and is outside of totex. While the proposal is outside the scope of the interim determination, we have taken this proposal into account in assessing Anglian Water's application.

Alongside its application to amend price controls, Anglian Water has 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. 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 are consulting on the proposed change within this document. We set out Anglian Water's proposal and our draft decision in more detail in section 3.2 below.

2.3 Our approach to assessing Anglian Water's application

We have assessed Anglian Water's application in accordance with our statutory duties and the strategic policy statement of the [UK Government](#). Our statutory duties¹ 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
- 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.

What is a draft determination?

¹ 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.

A draft determination of an interim determination represents our view of the claims that a company makes in respect of an interim determination application. Our view is informed by the information available to us at the time. This includes information that is provided to us:

- by the company in its interim determination application;
- by the company in response to any queries we have raised;
- by other companies to help inform any comparative assessments (where relevant); and
- other information we have available from other sources, including our final determination at the last price review and, in Anglian Water's case, the CMA's redetermination.

The draft determination provides all interested parties, including the applicant, an opportunity to make representations to us on the information we have used to make our draft decision and on the draft decision itself.

We will consider all responses to the draft determination in reaching our conclusions for the final determination.

3. Assessment of Anglian Water's costs and other consequential changes

3.1 Totex

Anglian Water's application sets out the costs it believes are required 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 these two components. The request is comprised of:

- £87.867m capex to deliver the conditioning plant and transfer pipeline
- £0.220m opex to recognise that the assets will be in operation in the final year of AMP7
- a reduction of £4.353m opex to return an element of the DPC costs it was allowed at PR19 and no longer needs to incur.

The costs are in line with those requested by Anglian Water in its PR19 Business Plan submission subject to the application of a frontier shift adjustment, which the company has applied. Frontier shift is the expected productivity improvement that the sector as a whole is expected to make in the AMP, and it reflects that even the most efficient companies are able to increase their productivity over time due to, for example, new technology. In our final determinations at PR19, we applied a frontier shift challenge of 1.1% per annum. In the CMA's redetermination for Anglian Water, it reduced the frontier shift challenge to 1% per annum. Anglian Water has used the frontier shift efficiency challenge determined by the CMA in its final redetermination.

Our assessment of the claim

As the whole Elsham scheme was identified to be suitable for delivery via DPC, we did not make any provision in our PR19 final determination for Anglian Water to deliver the project in-house. Instead we allowed £9.397m for Anglian Water to design the project, to prepare it for delivery via DPC, and to put it out to tender.

While we did not fund the scheme, at PR19 we did review and challenge the costs of Anglian Water's strategic interconnector schemes, of which the transfer pipeline element of the Elsham scheme can be considered to be part. We have, therefore, considered those PR19 challenges as part of this application.

At PR19, we made a downward adjustment to Anglian Water's proposed interconnector scheme costs. This was based on our view of,

- the required pipeline capacity;
- evidence of adequate optioneering; and
- a cost efficiency challenge.

Further information on the cost efficiency challenges we applied at PR19 to Anglian Water's strategic interconnector schemes is available [here](#).

In its final determination, the CMA allowed the full costs of the strategic interconnector scheme (subject to a frontier shift adjustment). As the first two parts of our challenge (the capacity of the pipeline and evidence of adequate optioneering) were discussed in detail throughout the CMA referral process, we do not propose to reopen those issues in this interim determination.

With regard to the efficiency challenges we made at PR19, as the CMA allowed the full costs of Anglian Water's strategic interconnector scheme, we do not propose to apply any additional efficiency challenges to Anglian Water's proposed costs. Our view is reinforced by the additional information Anglian Water provided through the CMA appeal process and to us as part of its interim determination application, including:

- a cost breakdown at an appropriate level of detail;
- an explanation of the calculation of project overheads and location factors; and
- evidence that its unit cost for the transfer pipeline is within the expected range based on expert judgement, and in line with market testing of indicative strategic interconnector schemes.

We, therefore, have accepted Anglian Water's proposed costs for the conditioning plant and transfer pipeline as efficient.

In addition to the additional totex requirement for the conditioning plant and transfer pipeline, Anglian Water is proposing to return £4.353m. This amount was part of the DPC costs we allowed at PR19. At PR19, we allowed £9.397m comprising:

- £6.812m design costs
- £1m pre-tender costs
- £1.135m tender costs
- £0.450m contract management costs

Anglian Water is proposing to return £4.353m of the design costs in order to avoid double counting and to ensure the allowance for design costs only reflects the costs for the water treatment works element of the scheme, which will still be delivered via DPC. It has not proposed to make any reductions in relation to pre-tender costs, tender costs, and contract management costs as it is still expecting to incur these for the procurement and delivery of the remaining elements of the DPC scheme – the 31Ml/d water treatment works.

We have scrutinised Anglian Water's calculation of the DPC costs to return to customers and its approach is in line with our calculation of design costs at PR19. We also considered whether other elements of the DPC allowance should be reduced and we set out our views below:

- **Pre-tender costs:** this was a fixed amount allowed at PR19 for each DPC scheme and therefore is not scalable by project size.
- **Tender costs:** at PR19 we set tender costs based on 1% of total scheme costs and we have, therefore, considered whether a scope challenge to these costs is appropriate i.e. to reflect that Anglian Water will deliver a smaller project via DPC. Anglian Water has argued that tender costs are not scalable by the size of the project and for smaller schemes like the new Elsham water treatment works, which has capital costs of only c. £40m (2017-18 prices), tender costs are likely to have a greater element of fixed costs. While we agree that tender costs are unlikely to be entirely scalable, particularly for pathfinder projects such as Elsham Water Treatment Works, we consider that Anglian Water will face lower tender costs from procuring a smaller, less complex project. We, therefore, have applied a challenge of £0.2m to tender costs.
- **Contract management costs:** at PR19 we allowed £150k per annum post award of the CAP agreement. These costs are therefore not scalable by the size of the project and we expect Anglian Water will still incur these costs on the smaller DPC project.

We have, therefore, challenged Anglian Water’s proposed reduction to the DPC allowance and consider it should instead be reduced by £4.553m.

What we have allowed in our draft determination

Following our review of Anglian Water’s application, our view of totex for the transfer pipeline and conditioning plain is £83.334m as shown in the table below.

Table 4: 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
Company view	0	0.071	26.397	43.774	13.292	83.534
Our view	0	0.071	26.197	43.774	13.292	83.334
Difference	0	0	-0.200	0	0	-0.200

3.2 Impact on Anglian Water’s performance commitments

There are three performance commitments in relation to the Elsham Transfer and Treatment scheme.

- PR19ANH_39 ‘Internal interconnection delivery’
- PR19ANH_47 ‘DPC underperformance incentive for Elsham treatment works and transfer scheme’
- PR19ANH_48 ‘DPC outperformance incentive for Elsham treatment works and transfer scheme’

The first commitment relates to the delivery of Anglian Water’s strategic interconnector schemes and holds the company to account for delivery. The latter two commitments require Anglian Water to successfully deliver the DPC project to various milestones.

The two commitments relating to the milestones for the delivery of the DPC project are still relevant and Anglian Water has not proposed in its application to amend them. However, Anglian Water has requested that we amend its first commitment, PR19ANH_39 'Internal interconnection delivery' to reflect that Anglian Water is now delivering the transfer pipeline and conditioning plant itself.

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 an additional 382.4Ml/d 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.

As we agreed at PR19 that the transfer pipeline and conditioning plant components of the Elsham Transfer and Treatment scheme were suitable for delivery via DPC, we did not recognise the benefits from these assets in the performance commitment. Anglian Water is, therefore, proposing to amend the performance commitment to include the transfer pipeline and conditioning plant, increasing its commitment to deliver additional capacity from 382.4Ml/d to 469.4Ml/d. It is also proposing to update the underpayment rate to reflect the increased totex allowance as a result of its interim determination application.

We have considered the impact of the interim determination on Anglian Water’s performance commitment and we agree that it is appropriate to amend the performance commitment to reflect that the company will now deliver the transfer pipeline and conditioning plant in house. Amending the performance commitment will protect customers’ interests should Anglian Water fail to deliver. We, therefore, propose to accept Anglian Water’s proposal and the table below summarises our view of the performance commitment in light of our draft determination compared to the current performance commitment.

Table 5: Proposed change to Anglian Water’s ‘Internal interconnection delivery’ performance commitment

	Current	Ofwat’s view
Performance commitment by 2024-25 (Ml/d)	382.4	469.4
Underperformance rate (£m per Ml/d)	0.460	0.459
Other changes		Insert transfer pipeline and conditioning plant schemes into table in performance commitment that lists schemes and capacity benefit

We note the small reduction in underperformance rate as a result of amending the performance commitment. The underperformance rate in the performance commitment is calculated with reference to the share of allowed totex that isn't automatically recovered through the totex cost sharing rate (45%) and the capacity benefit to be delivered by the strategic interconnector schemes, and this provides a pounds per MI/d figure that can be used to return money to customers where the capacity benefit is not delivered. By increasing the allowed totex and capacity benefit to include the transfer pipe and conditioning plant, there is a small reduction to the underperformance payment rate of £961 per MI/d.

We will publish the update to the performance commitment on our website once we have issued the final determination.

3.3 Bill impacts

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 have concluded that it is 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. As part of this, we have considered what rate of return is appropriate to use when setting allowances under this interim determination. We have considered whether to use:

- the weighted average cost of capital or the cost of debt (the rate of return upon borrowing specified in Anglian Water's Condition B as the Appropriate Discount Rate for standard interim determinations)
- If using the weighted average cost of capital, should we use the rate of return we determined at PR19 or that used in the CMA's re-determination

With regard as whether to use the weighted average cost of capital or the cost of debt, in relation to interim determinations relating to DPC projects Anglian Water's licence Condition B only prescribes the use of the cost of debt for the assessment of whether the materiality threshold is met. However, if there was a standard interim determination for Anglian Water then its licence states that the investment allowed for in the interim determination should be remunerated using the rate of return upon borrowing (the cost of debt). Given the context of the circumstances surrounding this interim determination, we consider it is appropriate to use the weighted average cost of capital. In coming to this decision, we have considered:

- the DPC framework;
- that had the transfer pipeline and conditioning plant not been identified for delivery via DPC it would have been funded in the wholesale water network plus price control using the weighted average cost of capital; and

- that Anglian Water's shareholders are bearing some of the risks around delivery of project.

In terms of whether to use the PR19 cost of capital or that re-determined by the CMA earlier this year, we propose to use the CMA's cost of capital because the CMA could have chosen to include the costs in its re-determination and for consistency with the rest of Anglian Water's programme. Therefore, for the draft determination, we have used the wholesale allowed return on capital of 3.12% ('Vanilla' weighted average cost of capital).

The tables below show our draft view of allowed revenue and bill impacts as a result of the interim determination. The change in allowed revenue and bill impact differs to Anglian Water's submission due to the challenge we have applied to the company's tender costs and also as a result of our a difference in approach to modelling the interim determination compared to in Anglian Water's proposal. Specifically, our approach to modelling has limited the impact of the interim determination to the wholesale water network plus control, whereas Anglian Water's approach resulted in small changes across the other revenue controls. This has led to differences in our view of allowed revenue at a price control level and bill impacts, however, our draft view of total allowed revenue at an appointee level is the same as the financial modelling included in its application.

Table 6: Water Network Plus Allowed Revenue

(£m, Real)	2020-21	2021-22	2022-23	2023-24	2024-25	Total
CMA redetermination	408.168	421.002	440.976	461.100	482.046	2,213.292
Draft determination	408.168	421.002	441.938	463.024	484.300	2,218.432
Change			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
CMA redetermination	394.06	387.60	396.87	404.73	415.49
Draft determination	394.06	387.60	397.21	405.42	416.28
Change			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.

4. Conclusions

We have reviewed Anglian Water's application and our assessment has found:

- 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 is requesting 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 exceeds the materiality threshold.

We have, therefore, accepted Anglian Water's proposed change subject to our challenge on DPC tender costs.

All stakeholders, including Anglian Water, now have the opportunity to comment on our draft determination, before we reach our final decisions and publish the final determination on 26 July 2021.

Stakeholders also have an opportunity to comment on our proposal to make consequential changes to the related performance commitment.

A1 Assumptions within our draft determination

This draft 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 draft 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 draft 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. Section 3.3 of the draft determination document sets out how we reached this decision.

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 draft determination, this means we use the 2019-20 appointed business turnover of £1,259.3m (2017/18 prices). By the time of the final determination, Anglian Water will have published its 2020-21 regulatory accounts and we will update our materiality test with the latest reported turnover.

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.

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.

Any enquiries regarding this publication should be sent to mailbox@ofwat.gov.uk.

OGL