love every drop
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PR14 Review: Discussion paper on findings

As stated previously in our January 2021 response to the call for inputs, we support Ofwat's ambition to utilise the widest range of inputs to help its future approaches to regulating the sector.

Since the initial call for evidence there has been substantial, more contemporaneous evidence, including the final redeterminations from the Competition and Markets Authority, and the outturn performance for the first year of PR19 (2020-21). This has also complemented by the collaborative engagement across the sector around Ofwat's PR24 and Beyond discussion paper and the range of working groups looking to potential changes to future regulatory approaches. In this context, it is important that any conclusions that are drawn are proportionate, well evidenced and consistent.

In this response we deliberately do not fully repeat our previous input into the call for inputs where we set out our views on the positive aspects of PR14, most notably with respect to the outcomes regime. Our emphasis in this response focusses on aspects of the PR14 review where we have drawn potential alternative conclusions to Ofwat.

We structure the remainder of this letter in line with the relevant chapters of Ofwat's paper as appropriate.

Securing value for money for customers

<u>Cost and ODI performance</u>

The key points in the PR14 review on the industry's performance against the cost and expenditure targets they were given at PR14 are these:

- through the performance framework (excluding SIM) companies earned net rewards of £33m; and
- companies over-spent their cost allowances by c. £500m, or 3.7%.

Ofwat's commentary on these facts suggests that they give a misleading view of the performance of the industry.

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On ODI rewards, it suggests that some ODI underperformance payments should be ignored, such that the 'underlying' industry reward was much higher.

On costs, Ofwat proposes several factors which suggest that the industry's 'real' under-performance is lower than the headline numbers suggest. These factors include that:

- companies advanced AMP7 expenditure into AMP6;
- there was some inefficient expenditure (£90m of inefficient leakage spend by Thames is particularly highlighted);
- there was a lack of innovation by companies; and
- some companies' spend included expenditure to earn ODI rewards.

In combination, Ofwat's commentary seeks to conclude that the PR14 package of cost and expenditure targets was reasonable.

Our interpretation of these facts is very different. We think that they show that the AMP6 cost and performance package that companies accepted at PR14 was very challenging.

We reject the adjustments which Ofwat makes in order to create its case, some of which have already been explored in detail. For example, the suggestion about advancement of AMP7 expenditure was subject to substantial debate during the PR19 CMA redetermination process where Ofwat made the same point specifically in the context of whether 2019-20 data should be used citing that this expenditure advancement as reason not to use this later dataset.

We and the other appellant companies set out in detail the evidence about Ofwat's claim. The CMA agreed with appellants that any potential bias is limited[1] and rejected Ofwat's case and did indeed use 2019-20 data. It is therefore surprising to find Ofwat re-citing this claim given it has been thoroughly investigated by a third party and rejected.[2]

The reported cost and performance outturns for 2015-20, i.e. the combination of significant cost under-performance and low ODI rewards demonstrates the potential asymmetric calibration of the PR14 package. These packages should allow companies to earn a return from improving performance standards and delivering efficiencies but, at the industry level, the PR14 determinations evidently failed to do so. This outcome, plus the emerging picture from the PR19 Final Determinations have important lessons for the setting of cost-expenditure packages at future price controls.

The evidence from the first year of AMP7 suggests that Ofwat has again set an asymmetric package of cost and expenditure targets.

Excluding C-Mex and D-Mex, only five companies earned net rewards from their performance commitments and overall the industry earned a net penalty of £25m (0.2% of their turnover). Bearing in mind that performance commitment levels were generally set to

[1] CMA Final Report dated 17 March 2021, Appendix C, para 83.

[2] The Early Start expenditure set out in Table 4B of the 2015/16 APR amounted to £140m across the industry carried over from AMP5. By comparison, the Transition expenditure carried over from AMP6 into AMP7 amounted to £94m across the industry. Both figures need to be taken into account to get a clear picture.

become more challenging as the price control period progresses, it suggests that by the end of the period the industry will be earning a material net penalty. The level of asymmetry was noted by the CMA in its redetermination and was accounted for as part of setting the weighted average cost of capital.[3]

On costs, the water and sewerage companies over-spent their totex allowances by £170m or 2.1%. Given several companies made slow starts to their first year enhancement programmes, it also indicates material likely under-performance by 2025. WaSCs overall outperformed the Ofwat forecasts for new properties by 6.4% in a year marked by Covid: as the pandemic morphs to endemic, growth looks likely to be a further factor driving cost over-runs compared to allowances, albeit one which will be mitigated by the DSRA.

Beyond these key take-aways from the PR14 review document, we comment further on Ofwat's reflections concerning the totex regime and on industry productivity.

Opex and Capex splits

Assessing cost performance on a totex basis worked. The evidence for this is that capex fell from around 58% of total expenditure in the previous three AMPs to 48% in AMP6 plus various anecdotal examples (including Ingoldisthorpe). There could be further still to go on the capex to opex switch in future years.

Productivity

In its consideration of levels of efficiency, Ofwat points to both inefficient industry spending (citing Thames on leakage) and a lack of innovation as factors leading to the 0.6% pa productivity measure for the industry reported by Frontier in 2017. Unfortunately, despite Frontier's recognition that quality was not adequately taken into account in its estimate of on-going productivity and Ofwat's own recognition (page 47) that *"...improved outcomes suggest overall better value for money for customers"*, Ofwat fails to relate these two observations. This thus highlights the importance of undertaking further work to incorporate service quality improvements into productivity measures.

Asset health and potential distortive effects

The paper suggests that the PR14 outcomes framework did not sufficiently incentivise a focus on the long-term resulting in the potential distortion that companies focussed on short-term delivery at the expense of longer-term objectives[4]. The suggestion being that delaying spend on capital maintenance enabled companies to focus investment on delivery against shorter term Performance Commitments with associated ODI rewards.

To support this hypothesis, (i.e. if CM spending had been delayed) one would expect material totex underspends in AMP6. However, as previously discussed there was a totex overspend across the industry during the AMP. Whilst there have specific cases of enforcement action during AMP6 where Ofwat has rightly intervened (i.e. Southern

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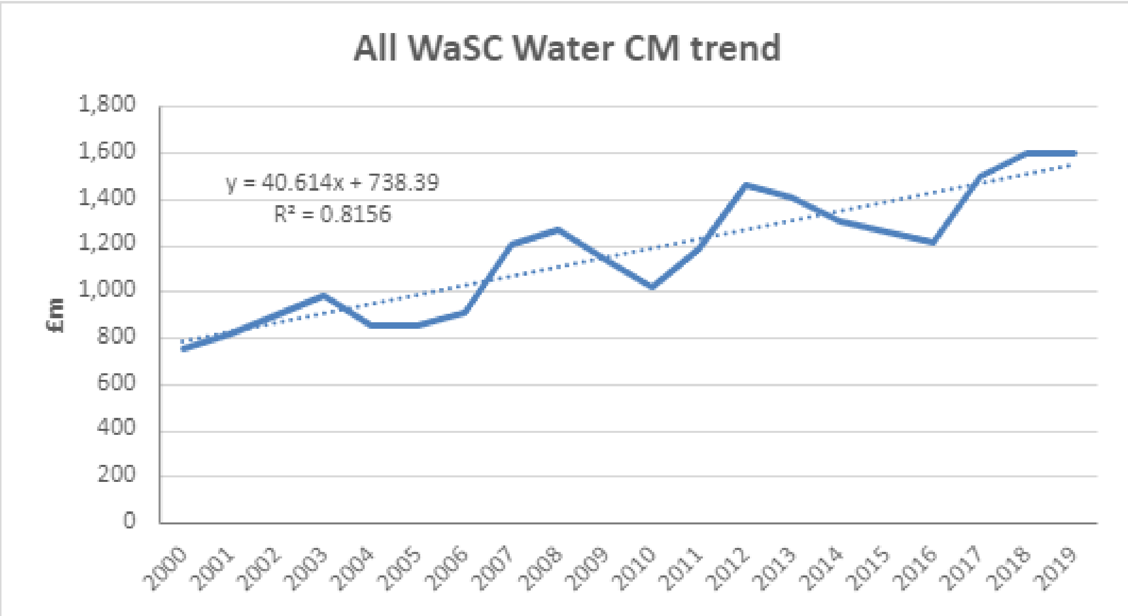
[3] CMA Final Report dated 17 March 2021, para 9.1344.

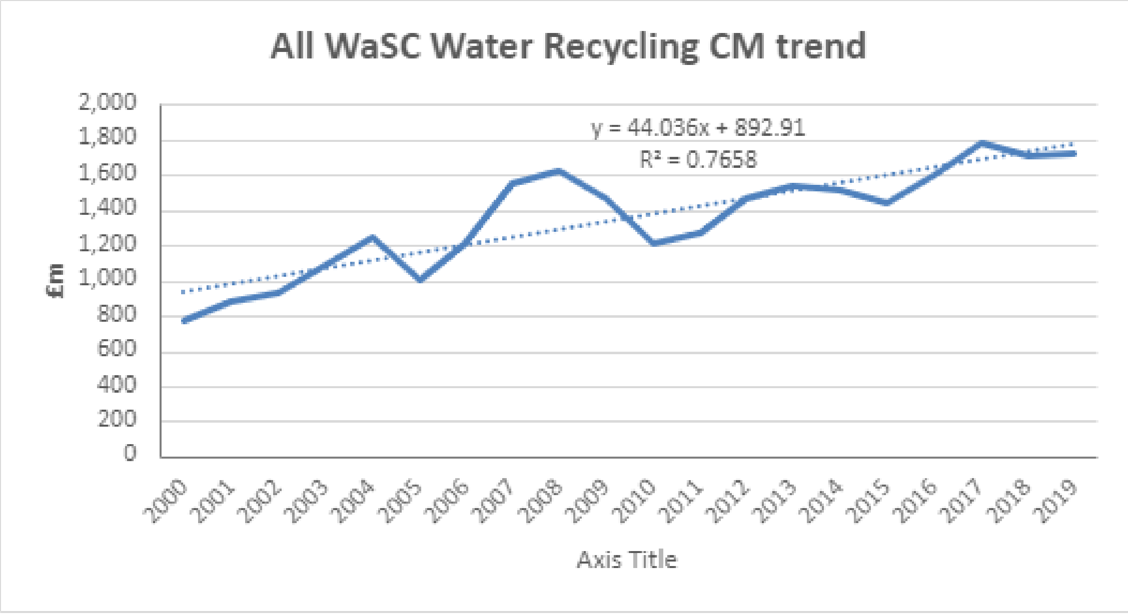
[4] Page 22

Water's wastewater treatment performance and Thames Water leakage performance), the broader hypothesis of a lack of focus on the long-term is not supported by evidence.

The expenditure data on Capital maintenance presented below demonstrates the industry's continued investment on capital maintenance in support of maintaining asset health. These profiles of companies' capital maintenance expenditure which show a clear upward trend, with investment higher in AMP6 than any previous AMP.



All WaSC capital maintenance including expenses renewals 2017/18 PB, using CPIH

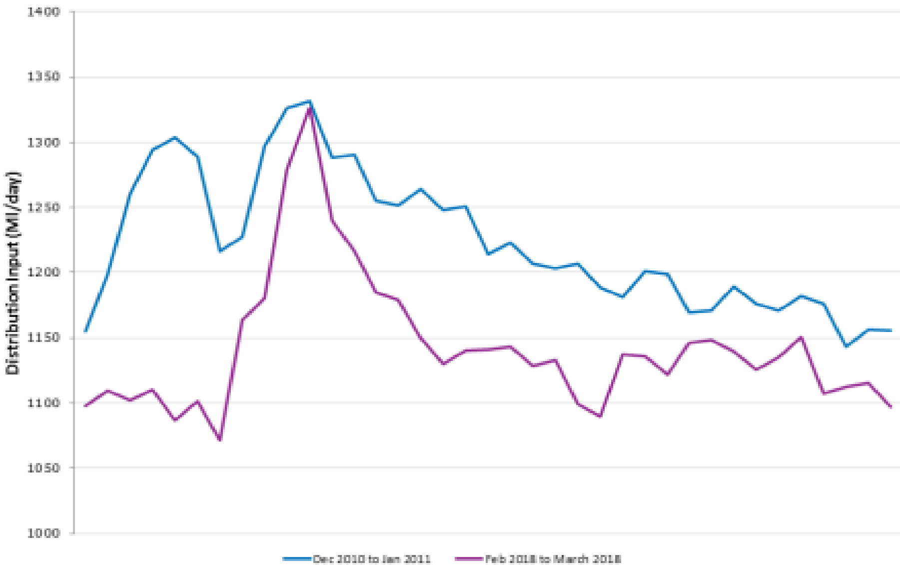


All WaSC Water Recycling capital maintenance including expenses renewals 2017/18 PB, using CPIH

Turning to Anglian specifically, our focus on asset health and other long-term priorities is unwavering, and a critical area of focus to deliver on our Strategic Direction Statement ambition "*To make the east of England resilient to the risks of droughts and flooding*". This is demonstrated through our strong performance across AMP6 asset health performance commitments as shown in the table below:

MEASURE	2015-16	2016-17	2017-18	2018-19	2019-20
Serviceability: Water infrastructure	**Green**	**Amber**	**Green**	**Green**	**Amber**
Unplanned interruptions >12hrs	1243	2459	1263	2267	19509
Reactive burst mains (variation from model)	-10	10	-11	0	-10.7
Customer contacts (discolouration)	0.39	0.41	0.36	0.37	0.37
Distribution Maintenance Index (DMI)	0.05	0.04	0.05	0.07	0.05
Serviceability: Water non-infrastructure	**Green**	**Green**	**Green**	**Green**	**Green**
WTW with coliforms detected	8	3	4	5	4
% service reservoirs with >5% coliforms	0.00	0.00	0.00	0.00	0.00
WTW turbidity	0	0	0	0	0
Serviceability: Sewerage infrastructure	**Green**	**Green**	**Green**	**Green**	**Green**
Pollution Incidents	81	105	113	82	123
Sewer Collapses	247	228	246	214	201
Internal Flooding	220	264	161	112	158
Sewer Blockages	11885	10522	11936	11908	12240
Serviceability: Sewerage non-infrastructure	**Green**	**Green**	**Green**	**Green**	**Green**
PE STW in breach of consent	0	0.17	0.48	5	0.01
STW failing numeric standards	0.84	0.42	1.11	1.3	1.06

Our focus on long-term resilience is evident when comparing our response to two similar extreme weather events which had a significant impact on our water network: the severe winter in December 2010 – January 2011, and the freeze-thaw event of February and March 2018.



Both events resulted in a significant increase in distribution input (DI) due to burst mains and leakage. However, as shown in the chart above, whilst the peak of DI was greater for the 2018 incident, the recovery time in reducing DI from this was much quicker. This improvement between two similar events was driven by a continued focus of the business over multiple AMPs on long-term resilience and asset health.

Ofwat's PR14 paper suggests that Ofwat's recent Asset Management Maturity Assessment has also highlighted that there could have been greater focus on asset health during 2015-20. We are keen to understand how Ofwat has drawn this conclusion and how it proposes to use the overall assessment as part of the emerging approach to PR24.

Our responses to the Asset Management Maturity Assessment also highlight how we have managed asset health and long-term resilience. For example, we capture and review asset health data through monthly reporting and have a full set of asset health data since 1990.

This data allows us to undertake long term trend analysis and overlay specific activities or events, for example the impact of the Section 19 programme for water mains reducing the long-term stress, or short-term shocks such as the Beast from the East. On water mains and sewers, we track the asset health data on a monthly basis, and we can review the season trends in asset health for different material types. We are also developing real-time monitoring and making progress on this through our Strategic Pipeline Alliance (SPA).

Notwithstanding the above, we reiterate our support for Ofwat's clear commitment to placing greater weight on the long term for PR24 and beyond, combined with a commitment to explore future approaches to capital maintenance assessment. We consider fresh approaches in this area will be critical to deliver both Ofwat's stated aims for PR24 and the long term ambitions set out in our Strategic Direction Statement in the face of the long term challenges, including climate change and growth pressures facing the sector and acutely impacting the region we serve.

Focus on delivery

As stated previously, we consider the introduction of the outcomes framework was arguably the best feature of PR14. At Anglian we immediately recognised the importance of the framework and aligned our performance management around it. The outcomes framework was therefore a key factor behind the performance improvements and the maintained focus on Asset Health we achieved for our customers and other stakeholders during PR14. This includes significant improvement in resilience with a significant reduction in water supply interruptions across the sector and for our customers a reduction of those served by a single supply system from 46.9% in 2014-15 to 22.7% in 2020-21.

This in contrast to PR19 where increasing stretch has resulted in overspending and underperformance on common performance commitments in 2020-21. As noted above, we do not agree that the sector's performance on cost can be solely attributed to expenditure brought forward. As such, the level of outperformance on performance

commitments appears appropriate in light of the level of expenditure, against what have transpired to be, stretching allowances.

Appropriate calibration of incentives, risk and return will remain an important area for PR24. We believe challenges to setting forward looking targets can be alleviated by further exploration of the link between cost and service. We welcome Ofwat's continued focus on this link in the current discussions through the Cost Assessment Working Group.

The current discussions and direction of travel for outcomes at PR24 is positive. We believe some of the complexity of the outcomes regime can be managed through greater consistency and formalising the differing categories of performance commitments into pure outcomes, price control deliverables and route for funding service improvement. However, we continue to believe that bespoke performance commitments will continue to serve an important purpose in reflecting the regional differences and the specific investment priorities companies face in delivering for their customers.

Risk and return

We agree with Ofwat that returns should be aligned with efficiency and service quality.

We note however Ofwat's conclusion that, "*in hindsight, however, the PR14 allowed return on capital was generous to companies*." The ex-ante allowed cost of capital was set in a world of uncertainty (where the potential outcomes and likelihood of different market scenarios were unknown as opposed to a world of risk in which they were knowable). It is important to avoid the decision trap of hindsight bias, not only for the allowed cost of capital but also for other areas such as totex and ODIs which we have discussed earlier in this response.

We agree with the view that analysis of companies' potential risk exposure is relevant. In this context, we also share concerns around the difficulty of robust risk estimation and quantification as well as the consistency of the approach and risk ranges across the sector. We consider that further work is required to address these issues at PR24.

In the Annex to this letter we share further comments on certain specific points raised around the allowed return on capital, including:

- Retail margin;
- Halo effect on cost of debt;
- Impact of regulatory decisions on financing strategy;
- Implications from Market to Asset Ratios (MARs); and
- Risks from derivatives.

Sustainable use of water resources

Incentives

We agree that the water trading incentive appears to have had limited impact during the 2015-20 period. As noted, it can take many years to identify and implement water trades. We are proactively developing several trading opportunities, largely with third

parties rather than incumbents due to a lack of water available for transfer. Trading is supported by initiatives that we have promoted including the Watersource platform, and work with Water Resources East. Although trading is motivated primarily by supply-demand balance issues, we believe that incentives are useful, particularly when these cover all types of trade. We continue to actively support Ofwat/RAPID working groups that are addressing barriers to trading and solutions, including future procurement arrangements.

Our experience of the Abstraction Incentive Mechanism (AIM) was limited to two sites in AMP6 and we did not find it to be an effective measure as there have been insufficient low flow days for the incentive to apply. This issue continues into AMP7 where we are limited to four sites and for the year 2020-21, only one site experienced a significant number of low flow days for the measure to be effective. Wilsthorpe experienced 114 days of low flow whereas our Marham (River Nar) source only experienced 1 low flow day and both Marham (groundwater) and Wixoe experienced no low flow days for the period. Further to this, one of our AMP6 sites was related to our abstraction at Costessey where there was no alternative source of water for our customers until we delivered a new £36million water treatment works. This demonstrates that AIM needs careful design to ensure it delivers benefits beyond those prescribed in existing mechanisms, such as licence conditions.

Leakage

Our ambitious plans for reductions presented for PR14 did not attract an ex-ante allowance and we subsequently spent more on leakage reduction in AMP6 (£27m on leakage enhancement, and additional botex from maintaining frontier performance) than we recovered through the ODI reward (£17m). Thus, the economic incentive to reduce leakage did not align with the supply-demand needs of our region. A critical aspect not recognised in the PR14 paper, is that companies are all at different starting points in leakage levels. Therefore, a simple comparison of percentage reductions is of limited comparative value given a 15% reduction for a company at the frontier will be more challenging than for poorer performing companies.

More fundamentally, there needs to be a recognition that both achieving and maintaining lower leakage levels costs more i.e. the incremental cost of leakage reduction increases as leakage levels are lowered. We welcome the work that Ofwat is undertaking with the industry on the collection of more granular cost and performance data on leakage maintenance and reduction to support this recognition in future price reviews.

Per capita consumption

We believe the industry has progressed on understanding and reducing PCC, but we note water companies do not fully control performance. This paper and the consultation on the PCC incentive for AMP7 highlight the need to explore opportunities to broaden focus beyond important intermediary measures (such as leakage and PCC) to more holistic outcomes, such as reducing abstraction, improving environmental quality and promoting water efficiency across the value chain. This is an approach we have seen successfully applied in Australia, where Yarra Valley Water is often subject to extreme drought conditions. We believe these broader outcomes should be incentivised through the

regulatory process. This would also align with the Government's thinking on targets to reduce water demand which is to focus on reducing distribution input in the Environment Bill. We are keen to explore this further with Ofwat and the industry as proposals for the PR24 methodology are evolving.

Targeting controls

We support and encourage improvements in transparency especially where they can help facilitate emerging markets that bring benefits to customers.

Whilst the separate retail control has improved visibility by highlighting cost differences, it is not clear that it has increased transparency as the reasons for those cost differences across the industry do not appear to have been well understood, nor that apparent efficiencies are either sustainable in the long run or are compatible with improving customer service. We note the recent discussions at the residential retail cost assessment working group focused on forward-looking costs, cost drivers and benchmarking, and we support further efforts across the industry to improve on the calibration of and justification for the costs allowed to the retail service going forward.

Retail indexation

Ofwat set out two reasons for its position which it took at both PR14 and PR19 on residential retail indexation – that there should be none. First, all retail costs are considered by Ofwat to be under management control. Second, Ofwat took account of companies' forward-looking costs, thus baking in forecast inflation.

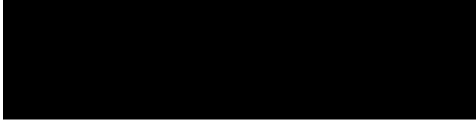
We address these two points in order. First, in a time of low inflation, as we have seen over the last decade, it has been possible for companies to cope with the lack of indexation, given that there has been an implicit quid pro quo of no frontier shift imposed on retail. It is important to note that capable of coping is not the same as having no impact. Given staff costs are the largest single category of cost for retail, our need to absorb wage inflation has put severe pressure on the business. Our call centre salaries have fallen from top quartile to bottom quartile in recent years. While it may be feasible to do this in the short to medium term, ultimately this is at the cost of increasing risk in terms of staff churn and lower staff quality.

Second, on forward looking costs, we would note the following: i) A key part of the rationale for using forward looking costs at PR19 was the abbreviated data set available at the time. By PR24 this will no longer be the case: there will be more than ten years' historic data by that point. ii) Although using forward looking costs bakes in companies' inflation expectations, the last few months highlights how quickly those expectations can change. Much better to assume a figure along with RPE & a true up mechanism.

With the ONS predicting 7.5% wage inflation, we suggest that Retail ought to be treated in the same way as Wholesale for PR24, with an assumed baseline CPIH increase, an assumed on-going productivity challenge and an acceptance of a Real Price Effect for wages, along with an end-of-AMP true-up.

We look forward to the continued, collaborative discussion to shape the PR24 framework. In the meantime, if there are any specific comments on this response; please do not hesitate to get in contact.

Yours faithfully



Darren Rice
Head of Policy and Regulatory Strategy

Cc: Aileen Armstrong, Senior Director PR24

Chapter 5 – Balancing Risk and Return

Section	Relevant Ofwat text	ANH Response
Overall		
p.6	In hindsight, however, **the PR14 allowed return on capital was generous to companies**. Assumptions on the cost of debt and the cost of equity both contributed to this.	It is important to be careful to characterise on an ex post basis the allowed return on capital as generous to companies as this risks hindsight bias. The ex-ante allowed cost of capital was set in a world of uncertainty (where the potential outcomes and likelihood of different market scenarios were unknown as opposed to a world of risk in which they were knowable). As a result in hindsight it is *also* possible that the allowed return on capital (ex-ante) was set too low and any ex-post outperformance was entirely driven by market changes (which companies were exposed to ex ante but were outside of the control of companies) rather than the allowed return on capital having been initially set too high. It is important to avoid the decision trap of hindsight bias (not only for the allowed cost of capital but also for other areas such as totex and ODIs).
RoRE		
p.61	The sector's weighted average RoRE over 2015-20 of 6.30% (real, RPI deflated) was higher than the base allowed return on equity (5.65%), suggesting the sector overall modestly outperformed the PR14 package […] Stripping out financing RoRE impacts, the weighted average RoRE would have been	Ofwat suggests that a deviation of 55bps (outperformance of 6.30% - 5.65%) from the allowed return implies that the WACC allowance was too generous. On the other hand, Ofwat claims that a deviation of 30bps (underperformance of 5.35% - 5.65%) excluding financing effects represents a reasonable outcome. It is not clear where the threshold lies between out-/under-

	5.35% for the period. This level of performance is consistent with a reasonable balance of risk and return.	performance being reasonable, and where it is a result of setting an incorrect allowance ex-ante.
p.69	Responses to our PR14 review call for input generally supported RoRE as a helpful metric to compare performance across companies on a common basis […] This notwithstanding, some responses raised issues with the RoRE risk ranges: • Complexity – one response voiced concerns around the difficulty of robustly conducting and quantifying the impact of scenarios, while another argued that stakeholders' understanding of RoRE was poor. • Consistency – several responses suggested that the approach to generating P10 and P90 figures was subjective and not done on a consistent basis, reducing comparability of risk ranges	We agree with the view that risk analysis of potential exposure is relevant. We also share concerns around the difficulty of robust risk estimation and quantification as well as the consistency of the approach and risk ranges across the sector. We consider that further work is required to address these issues at PR24. In particular it will be necessary to consider how to reflect and quantify structural breaks in risk, how to capture the interconnectivity between risks, and how to capture company specific factors in risk analysis.
Allowed return on capital		
Retail Margin p.70-71	**A retail margin:** We allowed the retail control a net margin of 1% on turnover instead of applying a weighted average cost of capital (WACC). To avoid double counting retail margin revenues in the Appointee WACC we made a 'retail margin adjustment' to derive a wholesale WACC which was applied to the wholesale RCV.	When Ofwat separated controls for retail and wholesale at PR14, the wholesale RCV included the existing retail assets. However, the wholesale RCV is now 'essentially free' of retail assets, as these have been mostly depreciated. Therefore, applying the wholesale WACC to the wholesale RCV does not remunerate retail assets. In fact, retail CAPEX spend is recovered via depreciation, but it does not earn a return on capital or even compensate for the time value of money. This will need to be considered carefully as part of PR24 calibration of returns.
p.72	The simple average interest rate for all companies over 2015-20 was 4.76% nominal, compared to the equivalent PR14 allowed return on debt of 5.36%. The median for large companies – which collectively accounted for 97% of March 2020 borrowings - was 4.55%. This suggests that, in hindsight, our index-based PR14 allowance was outperformed by most of the sector, and therefore	This is not correct. By the same token if rates had increased post PR14 a positive adjustment may have – with hindsight – appeared more appropriate. However, the 15bps downwards adjustment applied to the benchmark index was not made to protect against falling rates

	that our 15 basis point deduction from our benchmark index was insufficient.	(which could not have been predicted ex ante) but to reflect expected company outperformance relative to the index on an ex ante basis. As a result, the subsequent evolution of market rates is not even in hindsight relevant to the 15bps adjustment.
p.73	Considering both bond issuance data and company responses, it is therefore not clear that our PR14 index-led approach had any material impact on company financing decisions.	Irrespective of whether shorter dated issuance across AMP6 was driven by regulatory policy or other factors, it would be interesting to reflect on the risks such financing strategies might imply over the long term ahead of the financial resilience consultation in the autumn.
p.75	It is generally accepted that a MAR above one signifies a market perception that these companies will outperform the regulatory settlement over a long horizon… Positive market-to-asset premia are typically the result of multiple factors – one of which may be perceived outperformance on the allowed return on equity.	It is very difficult to read from MARs a robust conclusion around whether the market as a whole considers that regulated companies will outperform. CMA[5] dismissed the relevance on MARs on (primarily) two grounds: • Evidence from only two companies, both of which have lower than average cost of debt relative to the sector, cannot be relied upon to form a general conclusion; and • Share prices should reflect the long-term cash flow generation of a company. As such, focusing on outperformance over just one or two AMPs is likely to give an incomplete picture.

[5] CMA Final Report dated 17 March 2021, paras 9.1358 – 9.1362

		Inferences from market-to-asset ratios (MARs) as cross checks on the cost of equity estimated using CAPM are generally not reliable: (1) They are indirect estimates – the link between MARs and CoE is remote, (2) They rely on multiple complex and arbitrary assumptions about long term scenarios, which are hard to verify, (3) They are based on sporadic market data inputs, which do not represent efficient pricing signals.
Financial Monitoring Regime		
p.80	Risk from derivatives is a significant issue: some companies have large mark-to-market losses on their derivatives portfolios, constraining their credit quality.	Anglian disagrees with the incorrect characterisation of derivatives. Financial derivatives are a standard tool for management of risk exposure and can be argued to benefit customers as they de-risk the company. It can be said therefore that derivatives combined with a responsible and well drafted treasury policy do not pose additional financial risk and should not be considered as different to or distinct from 'pure' debt issuance.