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Dear [REDACTED]

PR24 and beyond: Long term delivery strategies

I am pleased to provide our response to Ofwat's PR24 and Beyond: Long-term Delivery Strategies and Common Reference Scenarios discussion paper.

The paper marks a significant development in the price review framework, shifting the principle focus from business planning over a five-year window towards long-term plans and contextualisation of companies' business plans within a long-term delivery strategy. As reinforced at the recent Ofwat workshop, we wholeheartedly support this development. Our sector naturally has a long-term focus and at Anglian Water we consider ourselves custodians of the assets and the natural environment which will be used by generations of future customers. This philosophy is underpinned by our Articles of Association which enshrine our purpose of delivering positive social and environmental outcomes for our region. We believe that this aligns with this evolution of Ofwat's regulatory policy as set out in this discussion paper.

We very much welcome the signalled direction of this PR24 discussion paper, which highlights a number of long term priorities that we agree are critical to the interests of customers and the environment. This is particularly true in our region given the acute challenges of water stress, flood risk, and population and housing growth that we face.

We support the development of long-term adaptive plans that seek to bring together multiple existing strategic planning frameworks, and to extend those principles over a wide range of outcomes. This approach encourages companies to identify long-term priorities based on the needs of current and future customers, and use this understanding to support the appropriate level of investment needed in AMP8 and beyond. The paper also outlines ways in which companies can prioritise low or no regret investments which allow the deferment of less certain investments.

This is particularly important for PR24 where the number of strategic priority areas (including net zero, water resilience, environmental improvements among

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other priorities) presents a risk of a large accumulation of potential investments. These must be appropriately prioritised, whilst managing both shorter and longer term bill pressures in a way which ensures intergenerational equity and timely service improvements for customers and the environment, whilst maintaining a financially resilient sector attractive to long term inward investment at the scale required to meet future challenges. The need for long term investment to meet these challenges is likely to create upward pressure on bills, so it will also be imperative to ensure a range of tools are in place, such as effective social tariffs to support those who are struggling to pay.

The discussion paper sets the scene for how PR24 and future price reviews will be framed, namely long-term, adaptive approaches to business plans in the context of long term delivery strategies. It is important that other aspects of the development of the regulatory framework such as approaches to the role of customer engagement, outcomes, cost assessment, risk and return, financial resilience and the overall assessment of quality of companies plans reflect this emphasis on the long term, and that the PR24 regulatory tool kit evolves accordingly and this is reflected in Ofwat's draft methodology.

Clearly this will require continued, collaborative thinking across companies, Ofwat and other regulators, and we are keen to play our part in this both for PR24 and subsequent reviews.

1. Adaptive planning

This paper positively builds on what was set out in Ofwat's initial 'PR24 and Beyond: Creating tomorrow, together' document on how to shift the focus of price reviews towards putting a greater emphasis on the long term. We support the paper's proposal to build the disciplines of adaptive planning – which have thus far been primarily used in WRMPs in the water sector – into the formal price review process. This will help to address some of the challenges which emerged for companies and Ofwat at PR19 around demonstrating the desirability of PR19 investments which would have greater benefits over the long-term compared to the benefits over a five-year period. For example, strategic growth investments where the efficient scope of investment will benefit both current and future customers.

Ofwat's Long-Term Delivery Strategy (LTDS) approach aligns with our thinking and builds on the approach we set out in our Strategic Direction Statement (SDS). The SDS, first introduced in 2007 and updated in 2017 after consultation with customers and stakeholders to provide the basis for our PR19 Business Planning process, sets out our vision for the future we and our customers want to achieve, looking ahead to 2045. It is in effect the "vision statement" for our region. It assesses the long-term challenges we face and sets the scene for delivering the long term social and environmental outcomes we have agreed with customers and stakeholders.

Our current SDS was not developed on an adaptive planning basis, but already having this vision statement prepared is helpful for us as we develop our LTDS.

Trigger points, which determine whether and when to switch pathways, are a key component of adaptive planning. These trigger points could relate to the common reference scenarios, changes in customer and stakeholder views, developments in understanding of the challenge to which an investment relates, among a range of other factors. We think that these trigger points should be defined at a high enough level to be meaningful and manageable without becoming overly burdensome, whilst also reflecting company specific regional issues. We support the approach Ofwat has highlighted in the discussion paper relating to allowances to enable companies to respond to trigger points. We would like to work with Ofwat and other companies on the regulatory implementation of these trigger points to ensure that they are appropriately consistent and adaptive within the price review process.

These trigger points result in changes to the long-term investment needed in the sector and opens up a route through which such trigger points will be reflected both in longer-term planning and price reviews. There is evidence in the current price review period that there is a necessary role for adaptive planning and associated trigger points.

For example, we would characterise the Covid-19 pandemic as an example of a trigger point companies have experienced. This pandemic has led to a sustained increase in PCC and the associated load received at our Water Recycling Centres, resulting in a step change reduction in the available headroom at Water Recycling Centres, and a sustained increase in expenditure to treat this. Another example could be the recent significant change in abstraction policy by the Environment Agency which has changed the expectations from those set out in WRMPs. Conversely, an adaptive approach allows the need for investment to be reviewed and reappraised. For example, our recent review of the need for the Middlegate Water Treatment Plant has identified potential alternatives with lower whole life cost, and lower carbon solutions which can still meet the need. We are currently having discussions with Ofwat on this matter. These live examples show the very real nature of trigger points and the benefits that could be brought from bringing adaptive planning into the regulatory framework.

We also consider that the LTDS must bring together all parts of the regulatory approach. This means that the approach in relation to the LTDS should be mirrored in the policy positions taken in relation to areas such as risk and return, financial resilience, common PCs, and base costs including capital maintenance, all of which are the subject of other current discussion papers. The LTDS approach should also fundamentally underpin the draft methodology to be published in summer 2022. As the LTDS will form such a central part of the price review, we see it as the framework document from which all other strategic frameworks and the assessment of the PR24 price review should hang. With this in mind, we consider that discussions and consultations on every part of PR24 should connect back to how that part of the price review links to the LTDS.

This approach is new for price reviews and represents a significant step forward in the regulatory framework. As such, the shift to adaptive planning and development of LTDS must be done proportionately. We must together ensure that the process isn't overly complex or prescriptive as this could distract from the most value-adding aspects of long-term delivery plans, and could risk creating an overly burdensome addition to the price review process, particularly for smaller Water Only Companies.

We consider that Ofwat may find it valuable to use the knowledge and experience of the sector in working up where the "common" parts of adaptive planning can be established and where there are the bespoke elements which are best left to individual companies. The LTDS document marks a significant shift in the approach from previous business plans and we believe collaboration will be key to ensuring this shift works well.

We think it would be a worthwhile exercise early in 2022 for companies and Ofwat to establish how the consistent, proportional application of adaptive planning principles can be agreed and ultimately translated into information and data requirements for PR24 which add most value.

The LTDS must support integrated planning across multiple strategic frameworks and presents an opportunity to bring joined up thinking across the strategic frameworks into one place. We are exploring for example, where we could use place-based thinking to deliver a joined-up approach across WRMP, DWMP, WINEP and other frameworks together within a catchment. This brings with it greater opportunities to identify mutually supportive solutions, bringing together multiple stakeholders. The LTDS would be the most appropriate place to consider such integrated planning at a strategic level, incorporating the adaptive planning process set out in the discussion paper. This integrated planning approach is alluded to in the discussion paper, but we consider that this could be stated more explicitly.

2. Incorporating Long-Term Delivery Strategies into PR24 plans

We consider that the LTDS approach must be capable of both looking back from the outcomes we want to achieve by 2050 and looking forward from 2025 in terms of deliverability and affordability of those outcomes. It is likely that these lenses might well not quite meet in the middle, at which point there will come a question of which one is given primacy, through consideration of least regret and best value solutions. Our understanding is that it will be for companies to present a clear and reasonable rationale for the low and high regret investments in its PR24 Business Plan, taking into consideration common and company-specific scenarios.

We should ensure that the pathways favoured by LTDS scenario testing are consistent with those reflected in other frameworks. In line with the point made earlier that an LTDS should be

considered to be an overarching framework, it is important that the assumptions driving WRMP, DWMP, WINEP and other strategic frameworks are all aligned with those driving the LTDS.

3. Common reference scenarios

We understand Ofwat's intended purpose of the four common reference scenarios as set out in the discussion paper is to understand how companies' enhancement expenditure could vary in each of the "high" and "low" variations of the reference scenarios. Ofwat is also clear that there is an expectation for companies to carry out wider scenario testing of its proposals which may, for example, combine a number of the common reference scenarios.

Of the four scenarios proposed, the technology scenario is the most difficult to make assumptions about. The pathway that this scenario follows is highly dependent on innovation which is very challenging or even impossible to set upper and lower parameters on over a long-term time horizon. The technology scenario is also one which – whilst important to include – currently falls short on some of the test areas presented (notably exogeneity given the important role of companies in driving technological development and adopting technology in the water sector). There is an opportunity here for companies and Ofwat to collaborate through further dialogue to develop the common scenario and ensure it is workable.

We note that the scenario on environmental ambition currently has a relatively narrow focus on abstraction. We propose that the scope could be widened to recognise broader environmental interventions by government and society, reflecting for example the requirements of the Environment Act and future legislation, as well as future customer priorities in relation to the environment. Recognising that there are a range of potential ways that this could be measured, and the need to keep the common scenario true to the principle of simplicity, we would like to work with Ofwat and other stakeholders to consider what measures could be used for this scenario.

We encourage Ofwat to bring the sector back together in January/February to work through some of these areas in more detail rather than waiting until the publication of the draft methodology.

4. Customer engagement

Whilst the challenges facing the sector might be similar across companies (i.e. climate change, growth, net zero transition), the scale of impact will vary in different parts of the country. We therefore expect customers will have different priorities on which long-term challenges should be prioritised and over which time horizon these should be addressed. There is therefore a clear need for company-specific customer engagement to feed into each company's LTDS. This is recognised in the discussion paper. Customer engagement will be key to developing an understanding of the outcomes that companies should be prioritising in the long-term.

There will inevitably be a link between the LTDS and the ongoing central customer research, though it is currently unclear from this discussion paper and the common performance commitments consultation how common performance commitments will align with long-term delivery strategies.

5. Links to cost assessment

The focus of the LTDS discussion paper is on enhancement expenditure and how this could vary. Whilst it is clear that future enhancement allowances will be the route for a substantial amount of the investment needed to deliver the long-term strategies, it is important to recognise that this enhancement expenditure will result both in one-off expenditure and on-going recurring expenditure in subsequent periods to maintain this improved level of service provided to the environment and a growing customer base. The increased ongoing base costs to maintain leakage at lower levels is one example of this. We will discuss the cost-service relationship further in our response to the 'Assessing Base Costs at PR24' consultation.

Given these multi-AMP interactions between enhancement and base, it is vital that the long-term delivery strategy approach reflects how future approaches to capital maintenance can inform future maintenance requirements and how these may need to evolve. The LTDS highlights the need for companies and Ofwat to consider where we need to get to in 2050 and understand what investment is needed to get there.

Ofwat's recent Asset Management Maturity Assessment (AMMA) presents a strong basis for considering companies' long-term approaches to capital maintenance. It is clear that there are differences between companies in relation to asset management maturity. Now that Ofwat has the information from this assessment, it should be used to determine the weight Ofwat places on companies' forward-looking view on capital maintenance needs.

We also consider that further discussion is needed on how the assessment of enhancement expenditure to meet these long-term challenges can evolve. The focus of the LTDS discussion paper on enhancement and the interweaving of enhancement investments into new adaptive planning approaches highlights the need to make changes to the assessment of enhancement investments at PR24. We would welcome further discussion with Ofwat on this early in 2022.

6. Long-term outcomes

Given the long-term nature of the strategies that are being discussed, it will be important to recognise that new and emerging risks and opportunities will present themselves over the time horizon to 2050. The impact of uncertainty on strategies to deliver outcomes will be partly addressed through scenario testing, however companies should also build into their plans the likely changes to the outcomes to be delivered by 2050.

There are likely to be some instances where continuously improving performance is inappropriate or infeasible (e.g. where customers feel the level of performance is sufficient given the cost of achieving that performance or where additional investment delivers minimal additional environmental value). We would welcome opportunities for further discussion with Ofwat on how to build this flexibility into long-term plans and the regulatory framework.

Over this time horizon it is very likely that there will be new priorities which are currently low or not a priority to customers, stakeholders and the environment, or where there is currently an unidentified need that materialises in future years. An example of this is the recent very rapid increase in priority of addressing storm overflows. The regulatory framework needs to be able to accommodate effective delivery of these unknowns, both in terms of outcomes and strategies. Conversely, the long-term framework should be able to adapt to any deprioritisation of outcomes over the course of the next 25 years.

The outcomes that companies should aim for are influenced by a range of factors including changes in customer priorities, public views and government policy as well as emerging issues (e.g. any new threats to drinking water quality). These are all significant sources of uncertainty that may affect what is seen as minimum or no-regrets investments in different circumstances. Whilst we can't predict how these will change, companies and Ofwat should test these pathways against feasible variations in long-term outcomes to ensure their impacts are not being ignored, whilst not seeking to second-guess changes in government policy or other external factors.

7. Potential implications for financeability

The use of adaptive planning measures will require flexibility around enhancement expenditure. In particular, any of the four drivers of uncertainty identified in the common reference scenarios, even in isolation, could require a substantial increase in enhancement expenditure (for instance, to increase operational resilience in light of climate change) in certain future states of the world. To the extent that one or more of these drivers materialises, this effect could be compounded, potentially resulting in significant demand for investment in future AMPs and associated bill changes leading to potential challenges for intergenerational inequity.

This reinforces the importance of designing a PR24 settlement which represents an attractive proposition for equity investors as well as taking into account affordability under different scenarios.

Companies must be able to finance their investment programmes under any of the future common reference scenarios (or combinations of these scenarios). When setting allowed returns and the overall regulatory package, companies must be financeable even under the higher totex scenarios.

Combinations across the four common reference scenarios will need to be carefully considered as (for example) high expenditure to support climate change policy might be a pre-requisite – but is

not necessarily correlated to the other common reference scenarios, which could independently imply high investment requirements.

8. Potential implications for the balance of risk and return

Reviewing the LTDS consultation together with the risk and return discussion paper there is not yet a clear link between analysis of long-term risk and common reference scenarios on a forward-looking basis and the wider balancing of risk and return. We think it is essential to develop this link and would welcome the opportunity to discuss this further with Ofwat and seek to develop a methodology which incorporates this link and balancing.

Our PR24 business plan will be calibrated to reflect assumed sequencing of enhancements over time, a certain assumed profile of totex over the long term and an analysis of risks to current and future customers as well as to Anglian of different options and scenarios.

It is not currently clear from the discussion paper how regulatory interventions will interplay with the long-term calibration exercise carried out by companies – or the Board assurance which Ofwat has outlined in the consultation – nor how Ofwat might trade off risks versus other factors such as bill impacts, efficiency, customer feedback, wider policy objectives in its evaluation of plans.

9. Potential implications of the totex delivery challenge

The approach set out in the discussion paper presents, rightly, large uncertainty around future states with companies being expected to develop business plans which can easily be adapted to the requirements of different future states. Risk for companies may be amplified by demands on a finite pool of resources (e.g. due to constraints in the labour market) alongside the delivery of more projects through DPC.

Any increase to water companies' risk profiles under different states of the world and across different scenarios might not be accurately captured by market evidence, which is typically used to set allowed returns. As a result it will also be important to carefully evaluate risks implied by each scenario, as different scenarios could introduce very different level of risks. It will be important to ensure that returns are commensurate with forward looking risk exposure across scenarios to ensure that (1) the industry can attract the equity investment required irrespective of the future state of the world and the scale and nature of the investment requirement; and (2) the calibration of the price control supports financial resilience.

The financeability and risk challenge posed by the uncertainty around future states should be viewed in the context of calibrating the regulatory package and as a cross check to allowed returns. In particular, Ofwat will need to ensure that the regulatory envelope can flex to allow companies to

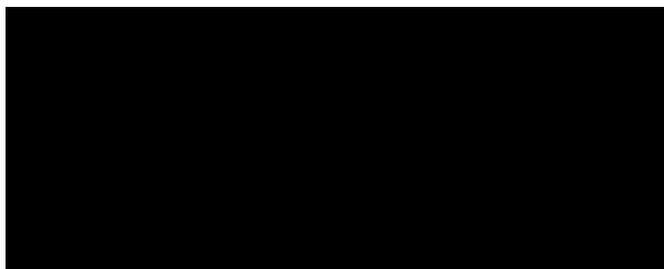
finance their functions in any of the possible future states, and that any increased risk exposure is consistent with the level of equity buffer.

10. Next steps

In closing, we would reiterate that we very much welcome this discussion paper and the long-term focus it signals, and look forward to working with Ofwat to develop this further.

As mentioned throughout this response there are several areas where we would welcome the opportunity for early dialogue with Ofwat to further support the implementation of long-term adaptive planning into this year's PR24 draft methodology.

Yours sincerely



Head of Policy and Regulatory Strategy