

## **Draft initial note on selected PCDs at final determinations**

### **Introduction**

We have produced this draft note in response to Anglian Water's request for our view on aspects of Ofwat's PCD framework as applied to selected PCDs that Ofwat has set for Anglian in its final determinations. This draft sets out our initial view based on a quick and high-level review of Ofwat's final determinations documents and associated spreadsheets to fit with the quick turnaround requested. A more in-depth review could result in additional information coming to light that affect the initial views set out in this document.

This note covers the following aspects of the PCD framework:

- The application of time incentives to partially delivered PCDs.
- The extent to which the PCD framework offers flexibility to Anglian Water to redeploy any underspends against enhancement allowances in selected areas.

### **The application of time incentives**

We have been asked to provide a view on how PCD time incentives would apply to partially delivered PCDs.

In its draft determinations, Ofwat proposed to use a two-way incentive that applies both outperformance and underperformance payments for the timing of delivery.<sup>1</sup> In relation to the application of the two-way incentive, Ofwat said at the time that it considered two options:

*“Option 1 - company can only face either underperformance or outperformance payments in each year, depending on whether it delivers the target output.*

*Option 2 - company can face both underperformance and outperformance payments in each year based on the proportion of the target output the company delivers. If the company delivers 70% of the target output, then it will face outperformance payments for this 70% and underperformance payments for the remaining 30%.”*

In the same document, Ofwat said that it proposed to adopt option 2.

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<sup>1</sup> Ofwat (2024) PR24 draft determinations: Expenditure allowances, p171-172, accessed on 21/01/2025 from <https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Expenditure-allowances-to-upload.pdf>

We have not found a reference to these options in final determinations, and Ofwat has not explicitly confirmed its draft determination position in relation to option 2. This makes it difficult to form a definitive view that can be relied upon.

However, there are indications in final determinations that Ofwat intends to apply option 2 as set out above.

- The final determinations included a statement from Ofwat that it has designed “*time incentive PCDs such that companies do not face underperformance payments as long as they deliver 75% of the benefit to schedule*”.<sup>2</sup> This statement, when read alongside Ofwat’s decision to calibrate time payments so that they are set at a third of the level of late delivery payments, supports the interpretation that Ofwat intends to apply option 2.
- Alongside its final determinations, Ofwat published a draft PCD reconciliation model.<sup>3</sup> This model includes calculations using illustrative PCD data that are consistent with the application of option 2 as set out in draft determinations. This model is clearly marked as a draft and therefore could change in the coming weeks or months. For what it is worth, the draft model provides some support to the interpretation that Ofwat intends to apply option 2.

Based on these references, it may be reasonable to proceed on the working assumption that Ofwat will apply time incentive payments in a manner that is consistent with option 2 as set out in its draft determinations. However, we strongly suggest that Anglian Water seeks formal written confirmation on this point from Ofwat as soon as reasonably possible.

## Flexibility to deploy underspends elsewhere

We have been asked to provide our view on the extent to which Ofwat’s final determinations provide flexibility to Anglian Water to deploy any underspends against enhancement allowances for other purposes that do not directly contribute to the delivery of the PCDs attached to those allowances. For this note, we have been asked to focus on four enhancement areas: phosphorous removal, storm overflows, sanitary parameters and WRC growth.

### The concept of an underspend under Ofwat’s approach

In considering the extent of flexibility to redeploy underspends, it is worth being clear about what underspends might mean under Ofwat’s approach. An underspend might be considered to arise if a company delivers a scheme (as specified by the cost drivers used in Ofwat’s enhancement modelling) and spends less than the associated allowance. The amount of money available for redeployment is that underspend, adjusted for any PCD payments determined by Ofwat at the end of the period.

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<sup>2</sup> Ofwat (2024) PR24 draft determinations: Expenditure allowances, p314.

<sup>3</sup> Ofwat (2024) PR24CA153-PCD-Reconciliation-model.xlsx, accessed on 21/01/2025 from <https://www.ofwat.gov.uk/wp-content/uploads/2024/12/PR24CA153-PCD-Reconciliation-model.xlsx>. This model is labelled as a draft, with company feedback to be provided by 14 February 2025.

On the face of it, Ofwat's approach to scheme-level PCDs (which include the four PCD areas that we've been asked to look at) involves a recalculation of allowances linked to the PCDs at the end of AMP8. If this recalculated allowance is equal to or higher than the corresponding FD allowance, Ofwat will not make an adjustment. If, on the other hand, the recalculated allowance is lower than the corresponding FD allowance, Ofwat will "claw back" the difference – which effectively means a lower allowance than allowed at FD.

Ofwat's approach to recalculating allowances does not explicitly involve any consideration of actual expenditure during AMP8 or an assessment of whether the scheme as planned has been delivered. Instead, the recalculated allowance will be determined by plugging in out-turn data for the applicable cost driver variables (with exception of population equivalent – PE) into the models that Ofwat used to set enhancement allowances at FD. The model coefficients used at final determinations will be retained and used for this recalculation. In effect, delivery will be assessed through its impact on the cost drivers from the enhancement cost models. It is not inconceivable that Anglian Water considers a scheme to have been delivered because the work set out in the plan was delivered, but the re-calculated allowance is lower due to changes in the cost driver used.

In addition, it is worth pointing out that we have found it hard to follow Ofwat's approach to re-calculating allowances for schemes labelled as "outliers", schemes that were subjected to deep dives and unmodelled schemes. One interpretation of Ofwat's documents is that these allowances for these schemes will be re-calculated using the same models as other schemes (which seems inconsistent with the basis for treating these schemes as outliers to begin with), but at this stage we cannot rule out some consideration of actual expenditure.

### **Supplementary conditions attached to delivery of PCDs**

Ofwat has set out various supplementary conditions that companies must meet before a scheme can be considered to be delivered and contribute to the recalculated allowance. We have not had a chance to carry out a comprehensive review and list all such conditions, but we did find a few statements that illustrate the broader point and contribute to the uncertainty.:.

- In relation to P-removal schemes, Ofwat said: "*For the schemes to be deemed delivered, we expect companies to secure confirmation from the Environment Agency / Natural Resources Wales that schemes have been completed in accordance with WINEP / NEP obligations. The solution delivered must be permanent and not temporary.*"
- In relation to sanitary parameters, Ofwat said: "*Given the sanitary parameters enhancement model in final determinations includes a scheme level and company level model, we will track delivery at the scheme level and claw back allowed investment in the event of non-delivery. We have set out an allowance for every scheme included within the model. We will hold the companies to delivering the schemes included in final determinations to meet tightened permit conditions for one or more sanitary parameters.*"

These statements (and this is certainly not an exhaustive list) could be taken to imply that Ofwat could over-ride the mechanistically re-calculated allowances and make further adjustments based on its assessment of whether its conditions are met.

## Other issues that create uncertainty

Ofwat has said things and acted in ways that create uncertainty about whether any underspends against recalculated allowances would indeed be available for redeployment without adverse consequences.

For instance, Ofwat's final determinations state: "*We include price control deliverables so that customers receive the storm overflow improvements and storage solutions that they have funded. Given the scale of improvement required on storm overflows, where our efficient cost benchmarks are higher than companies' costs, then we expect companies to deliver additional schemes in the 2025-30 period.*"<sup>4</sup> This statement could be interpreted to mean that any underspends against the storm overflow allowance should be used to deliver schemes that might otherwise be funded in future price control reviews.

Ofwat has repeatedly stated its desire to ensure that "customers should not have to pay twice" for allowed enhancements. While this is a reasonable objective, the question of whether or not customers have indeed "paid twice" is open to interpretation, and Ofwat has shown that it is capable of taking retrospective interpretations of what was actually funded even if it is not explicitly stated at final determinations. An example of this is Ofwat's PR24 position – not set out explicitly before PR24 draft determinations as far as we understand – that, as part of their base expenditure allowances, companies should have delivered a certain volume of mains replacement between 2011/12 and 2023/24 or experienced no increase in the proportion of mains in conditions grades 4 or 5 between the PR09 and PR24 data submissions.

There is a risk that Ofwat deducts any perceived AMP8 underspends from future allowances even if the company has spent that money elsewhere.

Furthermore, Ofwat has made public statements that could be seen as restricting companies' flexibility on underspends.

*"In parallel, Ofwat has ensured measures are in place to safeguard customers so money is spent where it needs to be spent; companies are responsible for delivering their investment programmes, and where companies fail to do so, funding will be subject to a claw back mechanism which will ensure money not spent on investment is returned to customers through lower bills.<sup>5</sup>*

There is also a possibility that companies will be held responsible for delivering their investment programmes (e.g. as specified in their business plans) in addition to the more explicit delivery requirements based on the cost drivers from the enhancement models and any supplementary conditions.

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<sup>4</sup> Ofwat (2024) PR24 draft determinations: Expenditure allowances, p123.

<sup>5</sup> <https://www.ofwat.gov.uk/ofwat-approves-104bn-upgrade-to-accelerate-delivery-of-cleaner-rivers-and-seas-and-secure-long-term-drinking-water-supplies-for-customers/>

There is also wider regulatory precedent from the UK energy networks sector for historical underspends being clawed back or set off against future allowances without explicit mechanisms to allow that being in place.

### **Other regulatory mechanisms**

Ofwat's final determinations include other mechanisms that could potentially interact with, and influence, Anglian Water's ability to re-deploy underspends against allowances. For instance, the delayed delivery cash flow mechanism (DDCM) could lead to an adjustment (even if transitional) based on the profile of actual expenditure against enhancement.

### **Our provisional view**

Our provisional view based on an initial review Ofwat's final determinations is that:

1. There is potential for Anglian Water to redeploy underspends within specific enhancement categories elsewhere, with the amounts available for redeployment dependent on (i) the outcome of Ofwat's recalculation of allowances at the end of the period in light of Anglian's delivery against the cost drivers used in the FD enhancement cost models; and (ii) on a number of supplementary conditions that Ofwat has attached to the PCDs.
2. But even then, Ofwat's recent statements and actions (and some wider regulatory precedent) means that it is not certain that redeploying underspends elsewhere would not have adverse consequences for either the regulatory assessment of delivery over AMP8 or price control allowances for investment in future periods.