

# **WSX-C20 – Cost adjustment claims**

Response to  
Ofwat's PR24 draft  
determination



**Wessex Water**  
YTL GROUP

FOR YOU. FOR LIFE.

## Representation reference: WSX-C20

### Representation title: Cost adjustment claims

#### CONTENTS

<b>1.</b>	<b>Summary</b>	<b>1</b>
<b>2.</b>	<b>Step up in capital maintenance / base costs</b>	<b>2</b>
2.1.	Introduction	2
2.2.	We have revised our approach to cost adjustment claims on the basis of engagement with Ofwat	2
2.3.	We have introduced a new cost adjustment claim: Step-up in capital maintenance / base costs	2
2.4.	Our new claim supersedes some of those included in our business plan	3
<b>3.</b>	<b>The industry-wide cost adjustments</b>	<b>4</b>
3.1.	Mains renewal	5
3.2.	Energy costs	11
3.3.	Net zero	12
3.4.	Meter replacements	12
3.5.	P removal	12

# 1. Summary

This document sets out our revised position in relation to the cost adjustment claims we are requesting; and our view on Ofwat’s industry wide adjustments.

## Our revised cost adjustment claims

As part of our Business Plan, we developed substantial evidence regarding our base costs and the level of capital maintenance needed. This was based on site and asset specific modelling of needs, lifespans, and efficient costs (based on market data). Ofwat’s draft determination was set on the basis of its econometric modelling, and not this evidence.

Since receiving our draft determination, we have engaged constructively with Ofwat on base costs. Looking to positively reflect this engagement, our draft determination response includes a new cost adjustment claim (“Step-up in capital maintenance / base costs”) which reflects the gap between our view of the efficient costs (based on our detailed bottom-up modelling); and Ofwat’s view (based on its econometric models).

This claim is consistent with the PR24 Methodology. This new claim has replaced, or superseded some of the claims included in our business plan (although we note, many of the considerations included in those claims continue to apply, and drive the need for this new claim). Specifically, evidence previously provided as part of our increasing costs over time claim (business plan document WSX08 and WSX09) is highly relevant and should be considered as part of this claim.

We provide further a summary of this cost adjustment in the next chapter; and full details in WSX-C01. Consistent with CW18/CWW18, the below table summarises the net value of the claim.

£m, 22-23 prices	WR	WN+	WWN+	BIO	Wholesale
Gross value of claim	£51	£723	£1,071	£272	£2,117
Implicit allowance	£41	£471	£952	£158	£1,622
Net value of claim	£11	£252	£118	£114	£494

## Ofwat’s industry wide adjustments

We welcome Ofwat’s industry-wide cost adjustments as a step in the right direction to mitigate the limitations of the base cost assessment methodology as it currently stands; however, we do not think the approach goes far enough.

There appears to be inconsistency in the approach adopted. What is needed is an over-arching framework for Final Determination to provide this, and to also set out the rationale for the inclusion / exclusion of industry-cost adjustments.

In terms of scope, we think an industry-wide adjustment for capital maintenance / base costs would be beneficial. We provide further exploration on this above with regard to what this would mean for our own costs; and we would be happy to engage with Ofwat about how this could be developed into an industry-wide cost adjustment.

Whilst we agree that customers should not pay twice, we consider there are limitations in Ofwat’s additional mechanisms for establishing whether outputs, or outcomes have previously been funded as we set out in WSX-C04.

Finally, we have a number of methodological issues with the individual claims themselves. These relate to the choice and non-comparability of data sources, assumptions and robustness of models. The negative cost adjustment on energy is somewhat divorced from reality.

## 2. Step up in capital maintenance / base costs

For further information see WSX-C01, a summary is provided below.

### 2.1. Introduction

As part of our Business Plan, we developed substantial evidence regarding our base costs and the level of capital maintenance needed. This modelling was based on site and asset specific modelling of needs, lifespans, and efficient costs (based on market data). We also highlighted concerns with Ofwat's approach and econometric modelling, which by design leads to underfunding of investment. We believe that using a bottom-up approach alongside cross-checks (including econometric models) is the most appropriate way to determine base expenditure requirements. The draft determination is based on these econometric models and does not address the concerns we raised; it also largely rejects our cost adjustment claims.

### 2.2. We have revised our approach to cost adjustment claims on the basis of engagement with Ofwat

Since receiving our draft determination, we have engaged constructively with Ofwat on base costs. In response to our query on the evidence submitted on our bottom-up modelling, Ofwat set out that: *"If you consider further cost adjustment claims are required, please submit these as part of your response to our draft determination."* Furthermore, in our company meeting we were asked to engage on this matter within the existing framework of econometric models and cost adjustment claims. Looking to positively reflect this engagement, our draft determination response includes a cost adjustment claim ("step-up in capital maintenance / base costs") which reflects the gap between our view of the efficient costs (based on our detailed bottom-up modelling); and Ofwat's view (based on its econometric models). This is consistent with the PR24 Methodology.

For the avoidance of doubt, we maintain that Ofwat's overall approach to assessing base costs does not sufficiently fund the efficient company (for the reasons set out in this document, and WSX-C01). However, our approach is intended to work positively with the regulator, within its framework, to ensure base costs are set at the right level. This is necessary to ensure that we continue to provide a reliable supply of water and wastewater services to our customers in the short- and long-term.

### 2.3. We have introduced a new cost adjustment claim: Step-up in capital maintenance / base costs

In the absence of perfect information, in any given price control it is hard to identify the appropriate level of capital maintenance and asset replacement activity, and therefore the efficient level of base costs to fund them. This is because the long lifespan of water assets, as well as the variation in the profile of the type and age of assets between different companies, leads to inherent uncertainty around the level of maintenance each company's assets require over time.

Previous price controls have focused on reducing customer bills, which has been achieved through a trade-off with delivering long-term investment, and has put pressure on companies' expenditure. A repeated ratcheting of companies' expenditure over successive price controls has resulted in underinvestment (especially in relation to capital maintenance where the negative outcomes are not immediately obvious) as companies have struggled to keep in line with their regulatory settlements, focussing on short-term outcomes while balancing pressures on costs and financeability.

In theory, econometric benchmarking can be a useful tool to help identify the efficient level of base costs because it uses the actual expenditure made by water companies to deliver their core activities, while controlling for factors that differ between the companies. This relies on the following key assumptions:

- that companies are in fact making the necessary level of investment to maintain their assets;
- that historical costs are a good basis to predict efficient costs going forward; and
- the model captures the various drivers of efficient costs (including all differences between companies).

However, the complexity of assets in the water industry means that this is a difficult standard for any econometric model to achieve. Indeed, in practice the above assumptions don't hold for Ofwat's cost benchmarking models. We provide further detail in WSX-C01, key issues relate both the (i) the input data (which represents historical underfunding, and therefore underinvestment); and (ii) the specifications. Together, these implies Ofwat's costs models are not reflective of efficient future costs because they bake-in, and therefore perpetuate, historical underinvestment.

Despite being limited by the above factors, Wessex Water has a strong a track record of delivering efficiencies and high-quality outcomes for customers. However, we cannot continue delivering for our customers in the same way if we do not urgently invest in our assets in a way the industry has not in the past.

In the context of the limitations of econometric methods, the modelled costs included in the draft determination do not reflect Wessex Water's (or, in our view, any other companies') true efficient costs, and we cannot rely solely on them to deliver for our current and future customers. Therefore, we have leveraged our detailed investigation to understand the requirements of our assets, carefully identifying the priorities to balance this against affordability and deliverability, and built-up our costs line by line using a bottom-up approach.

On this basis, our draft determination response includes a cost adjustment claim: "Step-up in capital maintenance / base costs" which reflects the gap between our view of the efficient costs (based on our detailed bottom-up modelling); and Ofwat's view (based on its econometric models).

We are clear that our plan does not include any investment that has already been funded. We are not asking customers to pay twice. We have, over the last two decades and more, consistently ensured that we have effectively and efficiently spent all our capital maintenance allowance.

That is, we have spent in full the investment funded by Ofwat's regulation framework for maintaining our asset base. However, as set out above we have concerns regarding the level of capital maintenance allowed by Ofwat in the PR24 draft determination; and indeed previous price controls. Specifically, our view is that a step-up in capital maintenance is necessary to make up for historical underfunding and to meet coming challenges. This is supported by views from the National Infrastructure Commission (NIC) and the House of Lords, which indicates significant additional investment is required to ensure that water assets can deliver for customers and the environment in the long-term.

## **2.4. Our new claim supersedes some of those included in our business plan**

As set out above, our new cost adjustment claim has been introduced to reflect feedback from and engagement with Ofwat. On this basis, it has replaced, or superseded some of the claims included in our business plan (although we note, many of the considerations included in those claims continue to apply, and drive the need for this new claim).

The table below provides a summary of our revised position. In summary, our representation is made up of two cost adjustment claims - we retain our catchment and nature-based solutions cost adjustment and include our new "step up in capital maintenance / base costs" cost adjustment.

Table 1 – Revised position of our cost adjustment claims

Cost adjustment claims		Status
CAC1	Increases to efficient costs over time	Further evidence provided as part of CAC7.
CAC2	Mains replacement costs	Withdrawn, see our mains replacement representation to industry-wide claim (section 3.1 of this document)
CAC3	Growth at Water Recycling Centres (WRCs)	Withdrawn, see our growth at WRCs enhancement representation WSX-C10
CAC4	Catchment and nature-based solutions	Retained.
CAC5	Industrial Emissions Directive (IED) costs	Withdrawn, see our Bioresources representation WSX-C18
CAC6	Energy Costs	Withdrawn, see energy representation to industry-wide claim (section 3.2 of this document)
CAC7	Step up in capital maintenance / base costs	New claim, see section 2 of this document.

### 3. The industry-wide cost adjustments

Ofwat have proposed a number of industry-wide adjustments. We welcome this response by Ofwat as a step in the right direction to mitigate the limitations of the base cost assessment methodology as it currently stands; however, we do not think the approach goes far enough.

There appears to be inconsistency in the approach, assumptions and methodology both between Ofwat's assessment of industry-wide CACs and the assessment of company-specific claims, and within the industry-wide CACs themselves. The concept of industry-wide adjustments implicitly embraces the notion of non-uniqueness (that an adjustment is warranted even where it impacts more than one company) and yet non-uniqueness is reason cited to reject some of the company proposed claims. Within the industry-wide cost adjustments, on the one hand Ofwat recognise the activity additional to what may have been covered by base in the meter replacement cost adjustment, on the other hand Ofwat do not make recognition for additional activity in the mains renewal cost adjustment.

The methodologies proposed for the industry-wide cost adjustments do not appear to be consistent. There appears to be a lack of overarching framework which has governed the rationale for the inclusion / exclusion of industry-cost adjustments currently proposed or for the choice of methodologies for each, which have little read-across. We encourage these observations to be robustly addressed for final determination.

In terms of scope, we think an industry-wide adjustment for capital maintenance / base costs would be beneficial given (i) Ofwat's approach to setting cost allowances does not allow it to identify efficient future costs to ensure a sustainable level of asset maintenance (ii) The historical costs on which Ofwat's models are based are not appropriate to estimate efficient future costs (iii) Historically, companies has not been provided sufficient allowances to maintain asset health; and (iv) a bottom-up approach is likely to be most appropriate at PR24. We provide further exploration on this above with regard to what this would mean for our own costs. We would be happy to engage with Ofwat about how this could be developed into an industry-wide cost adjustment.

Whilst we agree that customers should not pay twice, business plans are typically accepted in the round and historically there has not been direct hypothecation between funding and delivery given the inefficiencies and poor incentive properties this creates; as such we find the imposed retrospective views of what we have been funded for difficult to comprehend or meaningfully reconcile.

We have a number of methodological issues with the individual claims themselves. These relate to the choice and non-comparability of data sources, strength of assumptions and robustness of models. The negative cost adjustment on energy is somewhat divorced from reality. We provide further information in the following sections.

### 3.1. Mains renewal

Ofwat has made a draft determination that we must deliver a renewal rate of **0.48% per year** through **base expenditure only**, with no enhancement funding or cost adjustment.<sup>1</sup> This is higher than:

- The mains renewal rate that we proposed was fundable through base at PR24 (0.24%)<sup>2</sup>.
- What other companies are expected to deliver through base expenditure. Companies on the whole are expected to replace at least 0.3% of mains per year with base expenditure if their asset health is above the industry average and 0.43% per year if below the industry average.<sup>3 4</sup>
- The industry was able to deliver through base or even total expenditure from 2011-2023 (0.30% and 0.32% per year respectively).<sup>5</sup>
- We have been able to deliver through base or even total expenditure from 2011-2023 (0.38% and 0.42% per year respectively).<sup>6</sup>

Ofwat has given us a more stretching target because their data shows that we have had, what Ofwat calls, a “*significant*”<sup>7</sup> increase in our proportion of Grade 4-5 pipes since PR09 (from 1.4% to 4.0%<sup>8</sup>). While Ofwat does not state this explicitly, “*significant*” appears to refer to anything greater than 2.2%.<sup>9</sup>

Ofwat utilises the following data sources in its analysis:

- **PR09 network quality data.** This company-level data shows the length of Grade 1, 2, 3, 4 and 5 pipes in each company’s network at PR09.
- **PR24 network quality data.** This company-level data shows the length of Grade 1, 2, 3, 4 and 5 pipes in each company’s network at PR24. Together with the PR09 network quality data, we refer to this as the ‘network quality data’.
- **Mains replacement timeseries.** This company-level timeseries shows total length of mains, total length of mains replaced and total length of mains replaced out of base expenditure. Data from 2011/12-2022/23 is actual data, whereas data from 2023/24-2029/30 is forecast.

In our response, we highlight that Ofwat should re-evaluate their targets and expenditure allowances for mains renewals because:

- The network quality datasets are not comparable over time, contrary to Ofwat’s claim<sup>10</sup> that they are.
- Ofwat’s method is too narrow in its scope and does not allow it to make the conclusions it has reached.

<sup>1</sup> PR24 Draft Determinations: Expenditure Allowances, page 36.

<sup>2</sup> PR24 Draft Determinations: Expenditure Allowances, page 37.

<sup>3</sup> PR24 Draft Determinations: Expenditure Allowances, page 31.

<sup>4</sup> PR24 Draft Determinations: Expenditure Allowances, page 32.

<sup>5</sup> Analysis of PR24 DD Mains renewals adjustments.xlsx.

<sup>6</sup> Analysis of PR24 DD Mains renewals adjustments.xlsx.

<sup>7</sup> PR24 Draft Determinations: Expenditure Allowances, page 34.

<sup>8</sup> Analysis of PR24 DD Mains renewals adjustments.xlsx.

<sup>9</sup> Yorkshire Water, deemed not to have a “significant” increase in its proportion of Grade 4-5 pipes had an increase of 2.13%. Analysis of PR24 DD Mains renewals adjustments.xlsx.

<sup>10</sup> PR24 Draft Determinations: Expenditure Allowances, page 32.

- The additional challenge that Ofwat has proposed for us, relative to other companies, is not well reasoned.

We discuss each of these issues in turn below.

In conclusion, the data and method that has motivated Ofwat’s decision to impose a significantly higher than average mains replacement rate for Wessex is fundamentally flawed and does not support Ofwat’s conclusions. Additionally, Ofwat’s suggestion that, without Wessex’ uniquely stretching challenge, customers would be paying twice for Wessex’ mains renewals is incorrect. This is because Wessex: (i) has consistently delivered a higher than average mains replacement rate; and (ii) sustains a relatively well maintained network in the context of flexibly delivering a wide range of outcomes.

### 3.1.1. The network quality datasets are not comparable over time

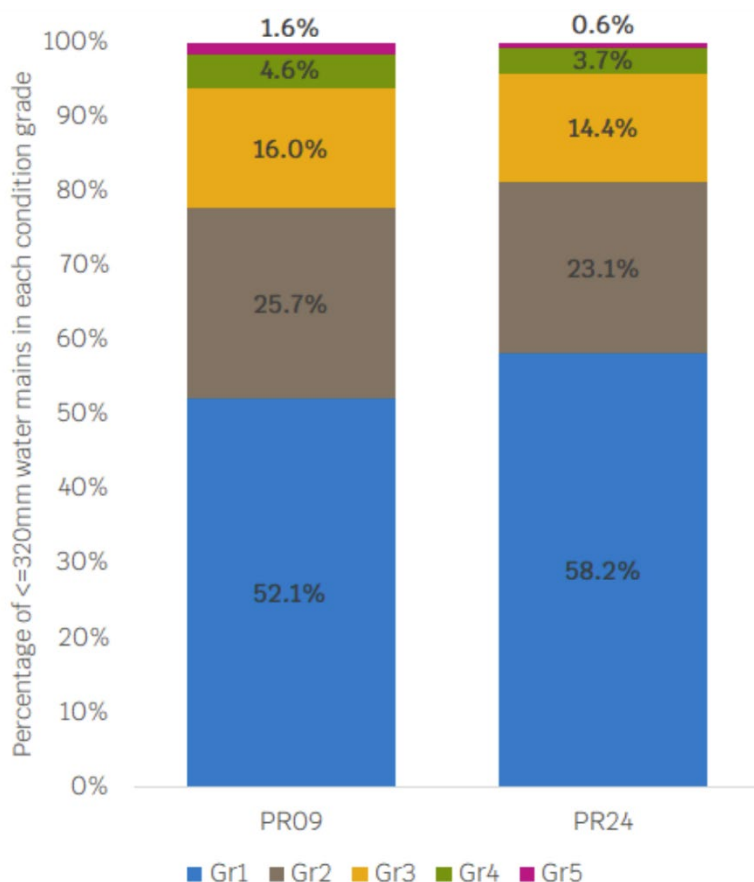
The network quality data is used by Ofwat to determine that our network quality has “*significantly*” deteriorated since PR09. However, the data is inadequate to support this conclusion because the PR09 network quality data and PR24 network quality data are not directly comparable. This is seen in two ways:

- The network quality data is inconsistent with the mains replacement timeseries.
- The network quality data compares the networks at two very distinct points in time.

#### ***The network quality data is inconsistent with the mains replacement timeseries***

Ofwat’s analysis, using the network quality data, shows that the industry as a whole had 51.2% Grade 1 pipes at PR09, relative to 58.2% at PR24. This represents a 6.1pp increase.

Figure 1 – Reproduction of Figure 4 from Ofwat’s Mains CAC Assessment

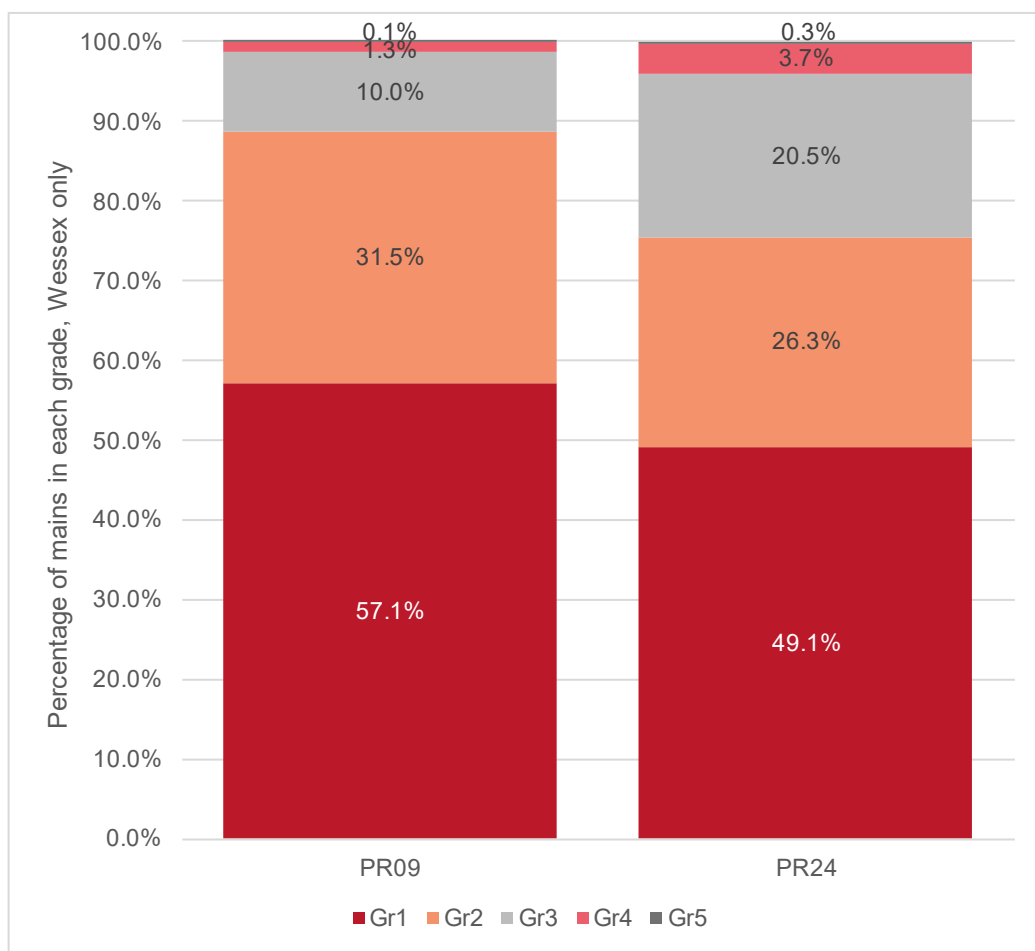




Simultaneously, Ofwat sets out (using the mains replacement timeseries) that companies have been replacing mains at a rate of 0.32% per year out of total expenditure. In the 15 years since PR09, this suggests that (assuming no decline in network quality whatsoever) that companies should have increased their proportion of Grade 1 pipes from 52.1% to 56.9%<sup>11</sup>, which is 1.3pp less than they appear to have replaced, based on the network quality data. This discrepancy would be even larger if (as would be expected) a proportion of those replaced mains would have declined in quality (e.g. to Grade 2) in that 15 years.

For our network, the equivalent discrepancy is substantial. The mains replacement timeseries shows that we have been replacing mains at an average rate of 0.42% per year out of total expenditure. In the 15 years since PR09, this suggests that (again, assuming no decline in network quality) we should have increased our proportion of Grade 1 pipes from 57.1% to 63.4%<sup>12</sup>, which is 14.3pp more than we see in the network quality data.

Figure 2 – The apparent deterioration in our network quality is inconsistent with the mains replacement timeseries



We consider that it is plausible that this discrepancy occurs in the data because mains quality has been reallocated over time, or other engineering logic.

<sup>11</sup>  $(0.32\% * 15) + 52.1\% = 56.9\%$ .

<sup>12</sup>  $(0.42\% * 15) + 57.1\% = 63.4\%$ .

### ***The network quality data compares the networks at two very distinct points in time***

By using just two data points (PR09 and PR24) in its analysis of network quality, Ofwat cannot understand how or why the quality of each network has changed over time. The simple ‘now’ and ‘then’ nature of the data does not allow Ofwat to consider how the networks have transitioned from PR09 to PR24. One key factor that Ofwat fails to consider is that the networks have grown in length over this time.

This dynamic is masked because Ofwat determines the change in the quality of companies’ networks by the change in the *percentage* of their networks comprised of each type of pipe between the two time periods. However, presenting the data in this way makes it, wrongly, appear that companies that have grown their total network size (i.e. total length of mains) have improved their asset health. This is because all new pipes, logically, will be the top grade of pipe (Grade 1). Put differently, all else being equal, a company that has grown their network from PR09 to PR24 will have decreased the proportion of Grade 4-5 pipes in their network (without replacing any Grade 4-5 pipes at all). This clouds the picture of how well companies are maintaining their assets.

This problem is material. We can see in the data that there is a large dispersion in the growth rate of company networks from PR09 to PR24, which range from -0.2% to 18.9%. This will cause a bias in Ofwat’s analysis that favours companies with large network growth.

If annual data was available, this impact of network growth could be accurately removed from the analysis year on year.

### **3.1.2. Ofwat’s method is too narrow in its scope**

We agree with Ofwat that the water sector needs to focus on ensuring the long-term resilience of its assets. This is highlighted in our base costs representation and underpins our increased investment in capital maintenance. However, Ofwat’s analysis of the issue and approach to solving it shows a failure in properly engaging with the issue.

Ofwat uses the network quality data to conclude that, on the basis that 4.3% of industry mains are Grade 4 or 5 at PR24 (seen in Figure 1), “[a]ssuming no further deterioration, the sector needs to replace mains at a rate of 0.43% per year on average to replace all grade 4 and 5 mains over the next ten years...we consider this a reasonable expectation”<sup>13</sup>.

Ofwat’s conclusion that replacing mains at a rate of 0.43% per year is “reasonable” is unfounded and ignores vital economic considerations:

- Firstly, Ofwat appears to have done no analysis to understand: (i) whether replacing all Grade 4-5 mains is economically efficient; and (ii) doing so in 10 years is economically efficient.

Replacing all Grade 4-5 mains may require a level of spending that is not efficient – that is to say, the costs of achieving perfection are not worth the required sacrifice in performance in other areas of the business. Ofwat does not consider the trade-offs that must be made to replace all Grade 4-5 pipes in company networks.

Furthermore, network quality is a spectrum that includes mid-quality pipes (Grades 2 and 3). In its assessment, Ofwat focuses on the proportion of Grade 1 pipes and Grade 4 and 5 pipes, and ignores companies with a large stock of Grade 2 and 3 pipes are at greater risk of long run network degradation.

---

<sup>13</sup> PR24 Draft Determinations: Expenditure Allowances, page 33.

If Ofwat is serious about addressing the issue of long-term resilience of assets in the water sector, it needs to identify: (a) the long-term sustainable level of asset *maintenance* activity (which may or may not require replacement); and (b) the short-term gap between that and the level of asset maintenance activity that is currently being undertaken.

- Secondly, even to the extent that one believes that replacing all Grade 4-5 pipes in the next 10 years is economically efficient, Ofwat appears to have done no analysis to understand the efficient costs of doing so. Specifically, it appears to simply assume that the efficient costs of replacing all Grade 4-5 pipes going forward is the same as in the past. This may or may not be the case.

For instance, companies may experience diminishing marginal returns to spending on mains replacement. Intuitively, there is a stock of Grade 4 and 5 pipes that are easier to replace than other pipes. It is rational for companies to target these pipes first as these will earn them the greatest improvement in network performance at the greatest speed and lowest cost. However, once these pipes have been replaced, the unit cost of replacing subsequent pipes increases. These accelerating costs will be worsened if there is a step change in replacement efforts industry wide, as we discussed in our business plan: “[t]his could lead to higher unit costs and deliverability issues as companies across England and Wales seek to [increase replacement rates]”. Ofwat has not considered the accelerating challenge of replacing Grade 4 and 5 mains in its assessment, nor whether mains replacement achieved historically through base expenditure is reflective of what could be achieved in future.

The data that Ofwat has compiled for its analysis gives very little to no information about these important factors of delivering main replacement. To optimise replacement rates across companies, Ofwat should consider why network quality and replacement rates are evolving in the way that they are, not just the raw outcomes such as the change in percentage of Grade 4 and 5 pipes. At present, Ofwat’s analysis of mains replacement is far too narrow in scope.

### 3.1.3. The additional challenge that Ofwat has proposed for us is not well reasoned

Ofwat has been motivated to set its mains replacement targets and spending allowances based on the principle of “[p]reventing customers paying twice for water mains replacement”<sup>14</sup>. This is built on the idea that if customers pay for a certain level of mains replacement in one price control but the company doesn’t deliver it, the company still ‘owes’ that service in the next price control even if they are not funded to do so.

Ofwat’s determination that we should deliver a higher than average mains replacement rate through base expenditure is not consistent with this principle for the following reasons<sup>15</sup>:

- **We have already been replacing mains at a rate higher than the industry average (through base expenditure).** As previously discussed, we have been replacing mains at an average rate of 0.38% per year through base expenditure, which is higher than the industry average of 0.30%. We have performed consistently above the industry average over the last 11 years<sup>16</sup>.

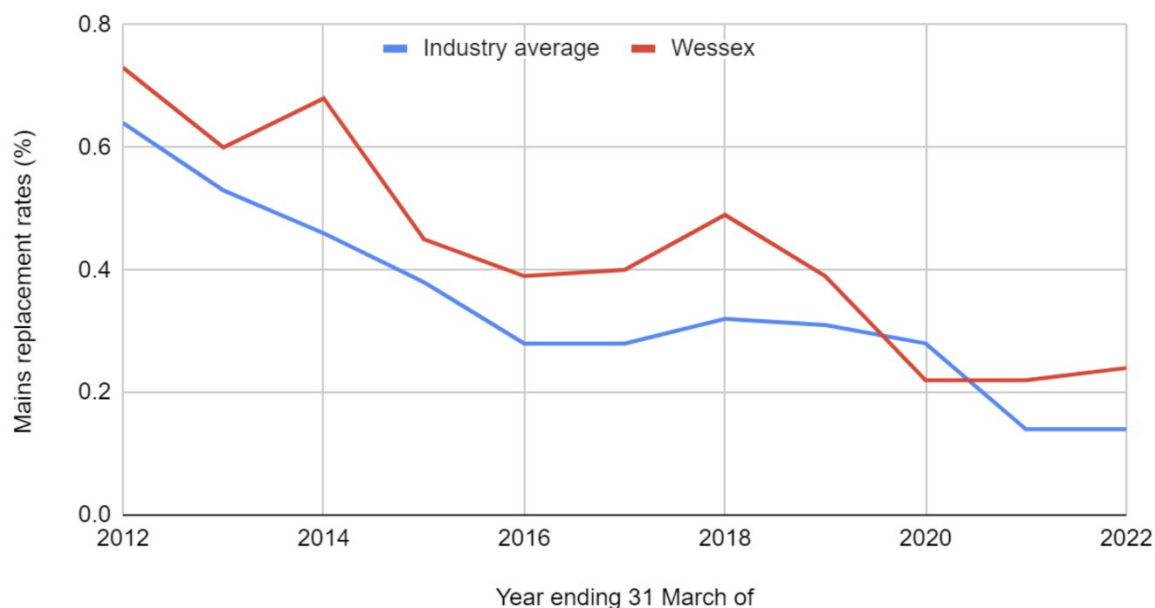
---

<sup>14</sup> PR24 Draft Determinations: Expenditure Allowances, page 34.

<sup>15</sup> Over and above the issues already identified with Ofwat’s data.

<sup>16</sup> <https://corporate.wessexwater.co.uk/media/r5mpqwop/wsx09-annexes-base-cost-adjustment-claims.pdf>

Figure 3 – Wessex has performed consistently above the industry average in mains replacement



On this basis, us receiving additional funding to finance mains replacement is not at odds with “[p]reventing customers paying twice for water mains replacement” as the level of service provided by Wessex is already greater than base cost allow for (i.e. what Ofwat has determined that “base buys”).

- The changes in the health of our network are a natural result of balancing performance efficiently across a range of outcomes.** In part 3 of Ofwat’s Mains CAC Assessment, Ofwat states that “[o]ur regulatory regime gives companies considerable **flexibility as to how they invest their base expenditure allowances to deliver good outcomes**...companies should manage cycles of maintenance across large, diverse asset bases within their long-term base expenditure allowance”<sup>17</sup>. This is consistent with the philosophy of setting wholesale cost allowances based on totex that Ofwat established at PR14: “PR14 moved from an approach where capital expenditure (capex) and operating expenditure (opex) were assessed separately, to an approach where we set wholesale cost allowances for total expenditure (totex). The totex approach went hand in hand with the move from outputs to outcomes, as it **allowed companies more flexibility to deliver customer outcomes in the most efficient way**.”<sup>18</sup> On this basis, amongst the competing demands of numerous service commitments, it is entirely rational for a company to refocus service quality from areas where it is industry leading to areas where performance is relatively poor. This is what we observe in Ofwat’s network quality data. We were one of the industry leaders in mains quality at PR09, with only 1.4% of mains in Grade 4-5 (the second lowest in the industry). Our apparent deterioration to a roughly-average performer is entirely consistent with the flexibility offered by Ofwat in its framework, rather than being evidence of customers being at risk of paying twice.

<sup>17</sup> PR24 Draft Determinations: Expenditure Allowances, page 34.

<sup>18</sup> Ofwat PR14 Review Paper, January 2022.

Figure 4 – Wessex was an industry leader in mains quality at PR09

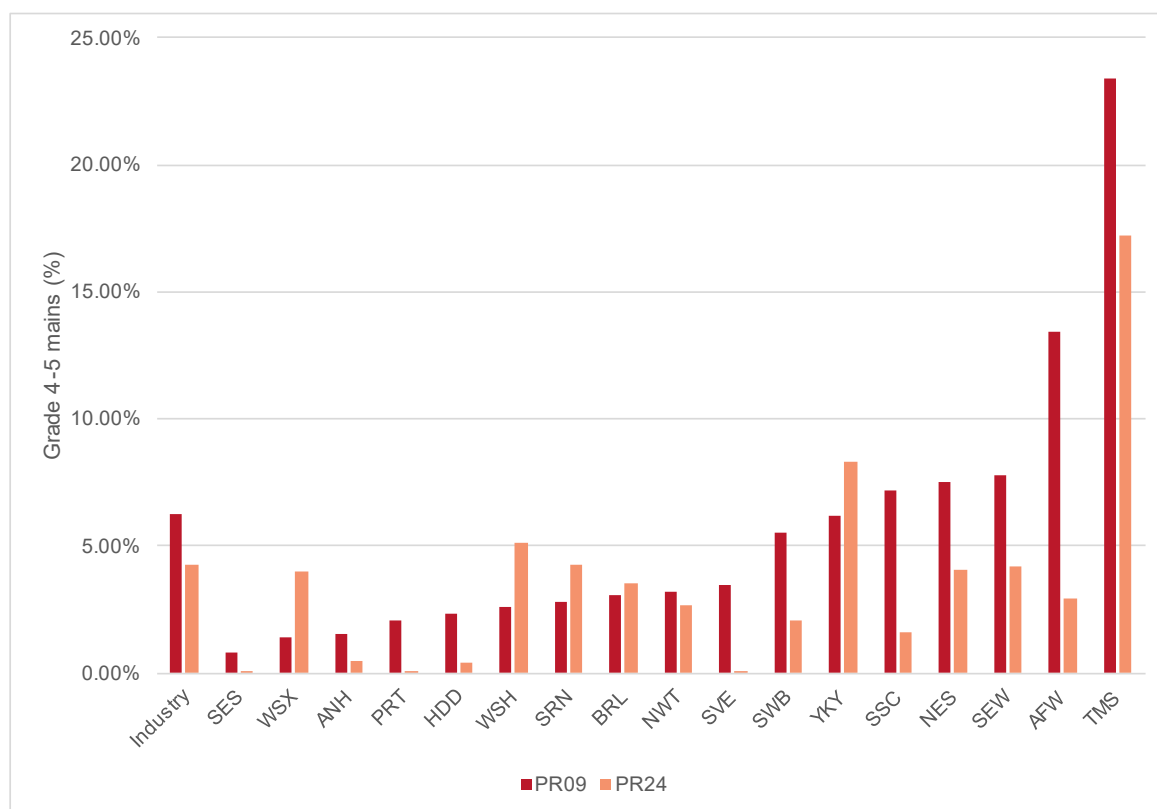


Figure 4 also reveals a further inconsistency of Ofwat’s challenge on mains replacement. We note that Ofwat has proposed to grant Yorkshire Water and Southern Water additional funding to meet the higher minimum mains replacement rate, since they have a growth in Grade 4-5 mains below the 2.2% threshold. However, it can be seen that Wessex has maintained a better network quality (fewer Grade 4-5 pipes) than both companies at PR09 and PR24. We consider that our actual network quality at PR09 and PR24, not just our change in network quality, should be factored in to Ofwat’s decision to apply additional stretch to Wessex.

## 3.2. Energy costs

The DD regulatory framework provides remuneration for energy costs through an industry-wide cost adjustment and an end of AMP RPE true-up. The direction that Ofwat is proposing in terms of the treatment of energy costs in PR24 is broadly appropriate, however the approach to implementation as currently proposed is flawed. The adjustment that Ofwat is proposing to modelled costs would actually reduce energy cost allowances by over £200m over AMP8 (2025-30). While an ex-post true-up mechanism, correctly calibrated, can rectify this it is not in the interests of customers or companies in terms of the balance of risk and providing appropriate protection. In the context of incentive based regulation, we do not consider that an ex-post adjustment should necessarily be used as a back stop in place of ex-ante methods. It is also not consistent with the duty of Ofwat as a regulator to provide allowances to cover a level of expenditure, efficiently incurred.

The core of this methodology hinges on the assumption that water companies are protected from volatility by energy hedge agreements and contracts with suppliers dated to 25/26. Water companies are no more insulated from market price movements through hedging arrangements and contracts than any other sector and full exposure is/will occur as those hedges and contracts unwind.

We provide further evidence of the limitations of the DD approach and more crucially, provide methodological recommendations for how the water sector can be more appropriately remunerated for these costs in AMP in the supporting report by WSX-C21 Annex 1.

### 3.3. Net zero

We set out our representation to net zero in WSX-C14.

### 3.4. Meter replacements

Section 2.2.2 of PR24 draft determinations: Expenditure allowances sets out Ofwat's approach to setting a sector wide cost adjustment to account for a step-change in meter replacement costs associated with smart metering programmes. Whilst we welcome the intent of this cost adjustment to remunerate companies for their uplift in expenditure on like-for-like meter replacements, we have some concerns with the model used.

Ofwat state they are *'holding companies to account for delivery of meter replacements they forecasted to deliver in the 2020-25 period and for which they were funded'*. Proactive meter replacements are funded from base expenditure. In section 2.2.1 relating to the mains replacement CAC, Ofwat state that companies have *'flexibility as to how they invest their base expenditure allowances to deliver good outcomes...companies should manage cycles of maintenance across large, diverse asset bases within their long-term base expenditure allowance'*. This statement is applicable to all base expenditure; therefore, we should not be held to account for delivery of forecast meter replacements from base expenditure when we have proactively managed base costs through AMP7 to deliver the best outcomes for customers and adapt to changing priorities.

On that basis, we do not consider that we have underdelivered meters in the past. At the price control level, we have consistently delivered high quality outcomes and cost efficiencies for customers. This has involved trade-offs and investment decisions in the context of our specific needs, and in the interests of our customers – as per the intention of the totex and outcomes framework. We therefore request Ofwat drops this downward adjustment in relation to metering, and indeed the other cost adjustment claims.

As set out above, we request that Ofwat consider revising their proposed meter replacement cost adjustment to remove the under-delivery element. This would result in our total adjustment allocation increasing from £12.22m to £19.83m. This funding is critical to the successful delivery of our smart metering programme on which we have already accepted an efficiency challenge on enhancement costs compared to those proposed in our business plan as described in WSX-C07.

The above considers the question of what base has bought, a retrospective view of which we do not support. Ofwat's approach to the meter replacement cost adjustment also seeks to identify what base can buy at PR24. The calculation of what base buys for PR24 meter installs is completely divorced from any implicit allowance analysis of the base econometric models – without further cross checks the implied number of meter replacements funded by base for PR24 is not well-justified or robust.

### 3.5. P removal

We set out our representation to p-removal in WSX-C09.