

## 1. QAA

We were very disappointed that our business plan was rated as ‘inadequate’ at draft determination stage, and we trust our response addresses Ofwat’s particular concerns. Our business plan was carefully developed to meet customer and government priorities. It provided for investment to double in the next five years compared to any previous five-year period. This increased investment is driven almost entirely by statutory and regulatory requirements, which in many cases have a disproportionate impact on the Wessex Water region.

We have very carefully considered the draft determination and its implications. We have addressed all the concerns set out in the quality and ambition assessment, including the challenge on specific areas of cost, as we detail in our representation on the QAA (WSX-M05).

On the basis of new information, we have sought to close the gap between our own and Ofwat’s view of efficient costs by applying further challenge to areas of new investment (e.g. to our nutrients programme) and the scale of our capital maintenance programme. Our revised plan is fully aligned with all PR24 statutory requirements. The financial modelling and data tables included in our response also use Ofwat’s draft determination cost of capital as required. However, we disagree with Ofwat’s view, and the approach to setting this so we provide an alternative view which we believe more appropriately compensates investors for the level of risk at PR24.

## 2. Cost of capital

We have carefully considered the overall risk and return package proposed in the draft determination. It is our view that the draft determination puts our ability to retain and attract investment at risk because the draft determination has not achieved the right alignment of risk and return and so a final determination that maintains this position would not meet Ofwat’s consumer and financing duties. This is because:

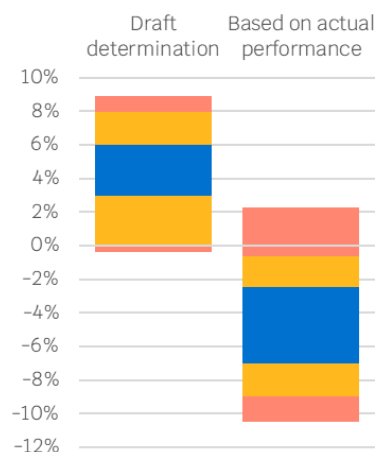
- The circumstances under which PR24 is being determined are materially different from previous price controls. The scale of investment at PR24 will be far greater than the recent past. This means Ofwat’s previous approach to setting the WACC (which may have been broadly appropriate in a different context) is increasingly likely to be inaccurate and undercompensate investors for the increased risks they face.
- Equity investors face an imbalanced risk package at PR24, with returns skewed to the downside. Outturn evidence demonstrates that PR19 was skewed to the downside (including for firms identified by Ofwat as being efficient); the source of this has not been addressed; and the PR24 methodology and draft determinations introduce additional sources of downwards skew.
- We encourage Ofwat to adopt a more holistic approach to setting the cost of equity, to ensure consistency with other price control parameters and support the economic growth objective.
- At a detailed level, there are issues in the proposed approach to setting the WACC using the CAPM, as set out in WSX-R01. These also contribute to it being below the level required to compensate debt and equity investors for the risks they face.
- The financeability assessment unduly focuses on debt credit-metrics, without properly considering whether the assumptions that underpin it are coherent. In our response, we propose a framework for ensuring the sector represents an investable proposition (i.e. ensuring “investability”).

## 3. Skew in returns

The approach to RoRE modelling in the draft determination makes many assumptions that we consider are inconsistent with observed data and technical feasibility. For example, impossible performance on some performance commitments (e.g. negative pollution incidents or negative CRI scores). To correct this, we think the risks should be considered through a lens of operational and asset management.

In WSX-R02 we set out a range of risks for the notional company that is based on (i) the proposals in the draft determination; and (ii) actual levels of performance over 2020-25. It gives a more intuitive picture of the risks facing the industry in the draft determination, which are recognised by the wider investor community. As shown in the table and chart below, the P50 for the notional company is negative at -3.97%

	Results of RoRE modelling for Notional Company		
	P10	P50	P90
Totex	-4.93%	-1.88%	1.03%
ODI	-3.68%	-1.72%	0.08%
Financing	-1.85%	-0.34%	1.19%
Revenue	-0.05%	-0.03%	0.00%
<b>RoRE (additive)</b>	<b>-10.52%</b>	<b>-3.97%</b>	<b>2.30%</b>



#### 4. Base costs

Since receiving our draft determination, we have engaged constructively with Ofwat in relation to base costs (i.e. through the company meetings and inbound query process). We appreciate this engagement and, looking to positively reflect it, our response includes a cost adjustment claim 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).

As part of our Business Plan, we developed considerable 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 believe that using a bottom-up approach alongside cross-checks (including econometric models) is the most appropriate way to determine base expenditure requirements in the context of PR24. The draft determination is based on these econometric models and does not address the concerns we raised. In our engagement with Ofwat we were asked to engage on this matter within the existing framework of econometric models and cost adjustment claims. We have introduced our new cost adjustment claim on this basis.

Since submission, we have further scrutinised the programme of works and scheduling that would be required to deliver this investment. To ensure we can deliver the necessary investment for customers, we are now proposing to profile some of this investment into AMP9, and consequently the base costs in our revised plan are reduced.

#### 5. Enhancement costs

We welcome Ofwat's objective to ensure all enhancement costs represent an efficient level. Ofwat's overall approach to enhancement is comprised of three key approaches: (i) econometric benchmarking; (ii) deep dives; and (iii) shallow dives. Between, and within, the three key approaches, our enhancement cost areas are considered somewhat in isolation. Under a balanced approach, we would generally expect cross checks to ensure the median, or notionally efficient company is funded to meet all its requirements. This is especially important in the context of a network industry where costs are complex and interrelated. We encourage Ofwat to consider this ahead of its final determination.

We support the use of cost benchmarking where it can be used to derive reliable estimates of efficient costs, and where the results are interpreted or cross-checked against all other relevant information. Given the complex and unique features of some investment proposals, we do not consider it is always an appropriate mechanism for setting cost allowances. Furthermore, we consider where benchmarking is used, the scope, specification, and results of models should be informed by - and cross checked against - operational and engineering evidence.

Having reviewed Ofwat's cost models, there are a number of areas where there may be issues relating to the goodness of fit of models, as well as over-reliance on uncertain forecast data. Where the current approach is primarily relying on cost benchmarking for its enhancement cost assessment, we are concerned that Ofwat's use, and interpretation, of modelled outputs should recognise and account for the limitations of its models. Our considerations, on a model-by-model basis are set out in our individual enhancement representations.