WSX-M02 – Summary of Wessex Water's response to Ofwat's PR24 draft determination

Response to Ofwat's PR24 draft determination

Wessex Water
YTL GROUP

FOR YOU. FOR LIFE.

WSX-M02 – Summary of Wessex Water's response to Ofwat's PR24 draft determination

This document is part of Wessex Water's response to Ofwat's PR24 draft determination.

More information can be found at wessexwater.co.uk

CONTENTS

1. Introduction

1.1. Our plan: summary

The Board of Wessex Water is committed to fulfilling our regulatory and public service responsibilities and we support Ofwat's wider objectives of restoring confidence and improving performance in the water industry. 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. Since submitting our plan, we have considered all available new information. On the basis of this 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 now fully aligned with all PR24 statutory requirements.

Our financial modelling and data tables in our response also use Ofwat's draft determination cost of capital as an input as required. However, we do 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.

We are clear that our plan does not include any investment that has already been funded and are not asking customers to pay twice. Our investors and leadership team have consistently ensured that we have effectively and efficiently spent all our capital maintenance allowance. Even so, we do have serious concerns about the level of capital maintenance allowed by Ofwat in the draft determination, which continues to reflect the underfunding from previous price controls. Our view is that a step-up in capital maintenance is necessary to make up for historical underfunding; and to meet new expectations.

Our Board is concerned that, even with our extensive support for customers struggling to pay, the consequences of this much needed investment on average bills will be significant, so to strike a balance, the real increase in bills should be less than 30% by 2030. Under this approach, our bills will remain lower in real terms, than those in 2009-10. That is, bills will have increased by less than inflation over 20 years.

We remain fully committed to the highest environmental standards and affordability possible in the circumstances. However, having 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. Given the size and scale of the investment programme, the downward risk skew created by PCs, PCDs, and other mechanisms, 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.

1.2. Our plan: meeting statutory requirements

Our business plan represents a doubling of investment which comes directly as a result of legal and regulatory requirements. In line with these statutory requirements, our plan, which has been revised in response to Ofwat's draft determination:

- Commits record levels of investment into reducing discharges from storm overflows, including through a programme of wetland creation in accordance with our strategy to innovate with environmentally sustainable solutions. This is consistent with the government's storm overflows discharge reduction plan.

- Includes over £1bn of investment to remove more nutrients out of our treated wastewater discharges and reach 'technically achievable limits' in the areas designated in the Levelling-up and Regeneration Act (LURA). Due to the higher sensitivity of the natural environment in the area we serve, 43% of our area is covered by nutrient neutrality rules. This is a far higher proportion than for any other water company (see below). We need to make this investment so housebuilding and growth can continue in these areas.

	Proportion of company area covered by nutrient neutrality
Wessex Water	43%
Southern	36%
Northumbrian	19%
United Utilities	17%
Anglian	7%
South West	5%
Dwr Cymru	4%
Severn Trent	3%
Thames	2%
Yorkshire	0%

- Delivers a number of supply enhancement and demand reduction activities that will enable us to abstract up to 20% less water from rivers and groundwater sources. This is in line with achieving legally binding targets under the Environment Act 2021.

- Aligns to the government's growth agenda with this level of investment bringing benefits to the region beyond those for water services and the environment. It will create jobs, provide work for our network of partners, and support wider economic growth.

We, and our long-standing shareholder, are committed to delivering this investment for the benefit of our customers, communities, the environment, and the wider economy. However, given the statutory nature, and scale, of this investment, to do this we must strike the right balance between the following key considerations: (a) securing investment; (b) ensuring affordability; and (c) successful delivery. In striking this balance we will leverage our track record of delivering our programmes on time and on budget, with high-quality outcomes for customers.

1.3. Securing investment

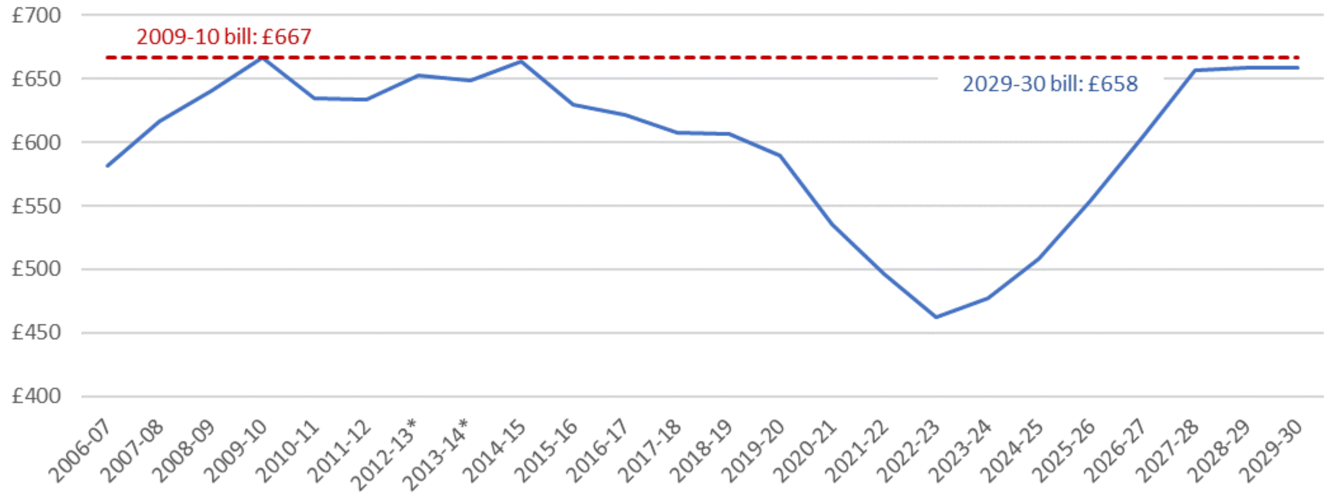
Our plan for 2025-30 proposes a step change in investment and performance levels. In this context, it is crucial to ensure that the overall risk and return package at PR24 supports companies in financing such a large-scale investment programme to deliver for customers and the environment in the long-term.

The draft determination includes a number of mechanisms which seek to recalibrate the risk and return package, this includes addressing some risks at source, as well as a revised view of the returns necessary to compensate investors fairly for the unmitigated risks. Having carefully considered the overall risk and return package proposed in the draft determination, we consider it puts our ability to retain or attract investment at risk. This is because the draft determination has not achieved the right alignment of risk and return, and so a final determination that maintains the draft determination position would not meet Ofwat's consumer and finance duties.

1.4. Ensuring affordability

We agree with Ofwat's argument that the scale of long-term investment required must take account of the long-term affordability of the programme by customers. As set out in our long-term delivery strategy, we expect the need for investment to continue in future AMPs so, on this basis, we do not believe that a short-term focus on reducing bills is appropriate. However, our Board is committed to maintaining affordability in the context of this much needed investment and has profiled bills so that the real increase in average bills over the period is less than 30%. This means our bills will continue to be lower, in real terms, than our 2009-10 bills, as demonstrated in the chart overleaf.

Figure 1: Real bills 2006-07 to 2029-30



Our framework for balancing this trade-off is set out in chapter 7 and further detailed in WSX-R06. This has also been discussed with our Customer Challenge Group, who "welcomes that the company is still planning to implement its original policies and processes around affordability and vulnerability for 2025 to 2030". We trust Ofwat will set its final determination within this framework. We understand that bill rises do not impact all customers equally, and our plan remains fully committed to eliminating water poverty by 2030.

1.5. Successful delivery

Since submitting our plan we have considered new information, including updated guidance from regulators; more mature designs and scopes for areas of new investment (e.g. our nutrient removal programme); and expert input on scope, costs and deliverability. On this basis, our revised plan is now fully aligned with all PR24 statutory requirements through to 2030, and beyond. Furthermore, with the creation of YTL's new construction company, our investors are strengthening their commitment to UK infrastructure delivery.

1.6. Leveraging our track record

At a time when the water industry faces a crisis of public confidence, we are judged by our regulators to be one of the leading water and sewerage companies in England and Wales on environmental and customer performance and outcomes. We recognise, however, that there is still a long way to go. This performance comes as a result of our continued investment to maintain and improve services for our customers.

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, we do have serious concerns about the level of capital maintenance allowed by Ofwat in the PR24 draft determination and in 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 indicate significant additional investment is required to ensure that assets are resilient and can deliver for customers and the environment in the long-term.

1.7. Innovation

Much of our plan is statutory, but we have a lot of innovative approaches to bring to bear, including:

- Pioneering the use of catchment and nature-based solutions, for example at water recycling centres where overflows are driven by high levels of groundwater.
- Introducing multi-benefit catchment markets in sensitive areas such as Poole Harbour, Somerset, and the Bristol Avon.
- The use of AI to better understand the condition of our assets so we can efficiently target our capital maintenance and to monitor our sewerage network to spot potential pollutions and stop them before they occur.
- Providing real-time information on the quality of recreational waters.
- New technologies such as advanced thermal conversion for biosolids treatment.
- Improving outcomes for our customers using digital technology for debt advice and to offering a wider range of contact options for all our customers.

1.8. Partnerships

We also can't deliver this plan alone and will need to leverage our strong partnerships, and develop new ones, including:

- The SSWAN initiative, which is an ambitious partnership aimed at addressing the fragmentation of regulation across different sectors and increasing the use of systems thinking.
- Collaborations with a wide range of organisations, from Rivers Trusts to community groups, the debt advice sector and Citizens Advice to maximise skills and funding opportunities.
- Our five Catchment Partnership Projects with environmental organisations and local authorities
- 21 flood risk management projects with Flood Defence Grant in Aid funding, aligned with our Drainage and Wastewater Management Plan.
- Maintaining strong relationships with local universities, collaborating on PhD research projects to further our scientific understanding on areas like emerging contaminants.
- Our Biodiversity Action Plan, which is based on strong relationships with local wildlife organisations and has contributed to regional biodiversity strategies, creating over 90ha of new habitat in the Poole Harbour catchment.

1.9. Ofwat's draft determination

In the context of the above, it is the Board's view that the draft determination does not appropriately balance investment, deliverability, and affordability. In particular:

- shareholders will not provide additional equity at Ofwat's allowed cost of equity, especially given it is lower than for other infrastructure investments;
- we cannot ensure our assets can deliver in the long-term by spending the same amount on capital maintenance expenditure that we had available at AMP7 (which, it is now well-established, was not sufficient);

- it is not appropriate for bills for our current customers to fall in the context of the significant increase in our investment programme, because it will mean that our future customers bear the costs of it;
- the introduction of price control deliverables has removed almost all flexibility and scope for efficiency in delivery; and
- the risk profile is significantly skewed to the downside, which would drive hundreds of millions of pounds of penalty, even for Wessex Water as a high-performing company.

It is important that the final determination is financeable, deliverable at the cost allowances, and provides a balanced risk and reward package.

1.10. Our response

Our response seeks to agree with Ofwat a way forward that both meets the regulator's expectation and takes account of Wessex Water's position. It is summarised in the remainder of this document; and detailed in our individual representations. In order to work constructively with the regulator and to achieve an improved outcome for all stakeholders, our response satisfies all the conditions set out in the quality and ambition assessment of our plan and we would expect this to be reflected in the final determination.

Our revised plan accepts Ofwat's proposal for additional stretch on key performance commitments (e.g. serious pollution incidents, leakage, and storm overflows); further cost challenge on areas of new investment (e.g. in relation to nutrient reduction and smart metering); and uses Ofwat's cost of capital, which we consider to be too low, in our financial modelling.

Finally, we note that PR24 is set in a context of unprecedented uncertainties. So, our response includes proposals for an uncertainty mechanism framework. We look forward to working productively with Ofwat to achieve an outcome that is acceptable to all stakeholders.

2. Our revised plan

Since submitting our plan, we have considered all available new information, taken on board Ofwat's comments and where possible either closed the gap or provided further evidence to support our position. This has included clearer or updated guidance from regulators and government; more mature designs and scopes for areas of new investment (e.g. smart metering); expert input on scope, costs and deliverability; and the submissions of other companies, which have enabled us to gain a deeper understanding in some areas that are new to us.

On the basis of this new information, we have partially closed 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. We have also included further investment for a number of areas where new requirements have come into place since we published the business plan, or our view of the necessary investment has been revised.

On the basis of our internal challenge and the additional requirements, at £3.65bn our revised investment plan is broadly equivalent to that in our original submission. The composition of this is summarised in Table 1.

Table 1: Drivers of investment (2022-23 price base)

Drivers	Cost (£bn)
Nutrient reduction	1.13
Maintaining asset resilience	0.94
Storm overflow improvement	0.45
Bioresources and IED	0.21
Wastewater treatment capacity	0.18
WINEP Improvements and investigations	0.26
New Development	0.08
Smart Metering, leakage and PCC Reduction	0.07
Continuous river quality monitoring	0.06
Other	0.27
Total	3.65

Key changes since our business plan submission are detailed in the following sections.

2.1. Nutrient reduction

We have identified the need for **£1.13bn** in enhancement funding for our nutrient reduction programme. This is a change to our business plan submission in that our revised plan is fully compliant with all statutory requirements through to 2030; and we have reviewed our view of the efficient costs in light of new information as set out below.

We have continued to engage with the Environment Agency and other regulators in relation to our nutrient reduction investment. Our updated submission reflects the EA's latest snapshot of the WINEP (5 July 2024) along with any subsequent agreed changes (up to 16 August 2024). Our revised plan is compliant with all statutory requirements through to 2030.

A significant proportion of the investment is driven by the Levelling-up and Regeneration Act (LURA) which requires us to upgrade water recycling centres in designated areas to reach the 'technically achievable limit' for nitrogen and/or phosphorus removal. This requirement is new, and therefore there is significant uncertainty about how it can and should be achieved. Since submitting our business plan, we have challenged our proposed scope, costs and delivery plans to ensure that our investment is delivering efficiently and effectively for customers. This has involved internal challenge; input from a range of external experts (including KPMG, AtkinsRéalis, and Galliford Try); and a review of other company submissions and real-life experience in this area. This has resulted in changes to our overall scope and costs. Further detail is provided on these changes in WSX-C09.

2.2. Maintaining asset resilience

Our revised plan includes **£941m** specifically for capital maintenance. As part of our business plan, we developed considerable evidence regarding the required level of investment. This modelling was based on site and asset specific modelling of needs, lifespans, and efficient costs (based on market data). 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. We further note this now includes investment in relation to pollutions and flooding, consistent with Ofwat's view that this increase in activity should be funded from base.

Since receiving our draft determination, we have engaged constructively with Ofwat on this matter (i.e. through the company meetings and inbound query process). Looking to positively reflect this, our draft determination 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).

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. However, we do have concerns regarding the level of capital maintenance allowed by Ofwat in the PR24 draft determination; and indeed previous price controls.

Our view is that a marked step-up in capital maintenance is necessary to address historical underfunding; and to meet future 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.

2.3. Storm overflows

We have identified the need for **£445 million** in enhancement funding for our storm overflows programme. This is an increase on our original submission as a result of a combination of a moderate decrease in costs and additional investment needs.

We have included additional storm overflow improvements since the business plan submission due to two new WINEP drivers which have been added by the EA. These are: shellfish improvements at Poole Harbour; and inland bathing waters. Both require additional storm overflow improvements to be added to our AMP8 programme. This has increased the overall cost of our storm overflows programme (whilst also significantly increasing the total volume of equivalent storage being delivered for customers and the environment).

We have also obtained more accurate information on required storage volumes at the original set of storm overflow improvement locations in our business plan. As this is an area where our investment is due to increase significantly, we have reviewed our scope and costs since business plan submission. Together, this has resulted in a moderate decrease in overall programme costs for the original set of improvements. With these, and a few other minor changes, the total storm overflow programme has grown from 128 improvements to 160 improvements.

2.4. Continuous river quality monitoring

Our revised plan includes Ofwat's view of the efficient costs for continuous river quality monitoring. Since submitting our business plan, we have received updated guidance from Defra on the expectations and scope of investment required. Furthermore, we have leveraged transition investment for preparation, mobilisation, and upfront expenses such as IT, labs, equipment etc. On this basis we have been able to revise our assumptions regarding some costs, and particularly the scale of land purchase necessary. Our revised view is marginally above Ofwat's draft determination view. We have therefore accepted Ofwat's view and will endeavour to deliver further efficiencies to meet it. The final guidance from Defra is yet to be published and we expect Ofwat will consider the implications of any material changes in its final determination.

2.5. Smart metering

Our revised plan includes Ofwat's view of the efficient enhancement costs for smart metering. Smart metering is a new programme for Wessex Water, and we have yet to appoint a delivery partner. Therefore, there remains considerable uncertainty around our own internal cost estimates. Since submitting our business plan, we have challenged ourselves to consider where we may be able to drive further efficiencies in our costs. This has included consideration of the cost proposed by other companies and their real-world experience, as well as our assumptions around installation job types. On this basis, we believe we can accept the stretch on cost efficiency resulting from Ofwat's enhancement allocation.

2.6. Water quality improvements

Our revised plan includes an additional **£18m** totex for our strategy in relation to per- and polyfluoroalkyl substances (PFAS). This is a result of further guidance and requirements set out by the DWI. This is to fund further research and planning in relation to particular water treatment sites.

3. Risk and return

3.1. Introduction

Our plan for 2025-30 proposes a step change in investment and, as a result, performance levels. We, and our long-standing shareholder, want to support the government's growth and environmental agenda and are committed to delivering this investment for the benefit of our customers. In this context, it is crucial to ensure that the overall risk and return package at PR24 allows companies the capacity to finance a large-scale investment programme to deliver for customers and the environment in the long-term.

3.2. The Draft Determination

The draft determination includes a number of mechanisms which seek to recalibrate the risk and return package. This includes addressing some risks at source, as well as a revised view of the returns necessary to compensate investors fairly for the unmitigated risks.

Having 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. Given the size and scale of the investment programme, the downward risk skew created by PCs, PCDs, and other mechanisms, 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 (and focused on more innovative projects), both to address historical underinvestment and meet challenging forward-looking statutory and regulatory targets. 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 also skewed to the downside (including for firms identified by Ofwat as being efficient), and the source of this has not been addressed (i.e. removed or offset); 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. The current approach to setting the cost of equity solely relies on the standard CAPM. However, the limitations of the CAPM are being increasingly recognised,[1] specifically that a narrow application of it fails to recognise interconnections between equity returns, investment, productivity, and growth (which is especially critical at this time, in the broader context of poor economic performance for the UK overall).

- 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.

[1] 'Exploring Multi-factor Models as a cross-check on allowed returns at PR24: Report prepared for Water UK.' KPMG (November 2022).

- The financeability assessment unduly focuses on debt credit-metrics, without properly considering whether the assumptions that underpin it are coherent.

We encourage a thorough review of the risk and return package at final determination. In the absence of change in the final determination, the financeability of water companies, and therefore the critical investment required at PR24 (and thereafter) will be at risk, further perpetuating the cycle of underinvestment in the water sector.

3.3. A framework for investability

As indicated above, given the scale of investment needed at PR24, the requirements for securing investment ("investability") needs additional consideration, and indeed more than in any previous price control.

Specifically, further examination is needed to expand the financeability framework and ensure the sector, and individual companies represent an investable proposition. On this basis, we have given considerable thought to what "investable" means and developed a framework for testing this. This is consistent with the principles of how an investment appraisal would be undertaken. A summary of this framework, and our assessment of the draft determination against it is presented in the table below and is further detailed in WSX-R05.

Figure 2: A framework for investability

Criteria	Assessment
Has the CAPM been calibrated taking into account the balance of the evidence?	Although the published analysis highlights the possibility of upward pressure (on RfR and impact of capital intensity on beta), this isn't reflected, even in the top end of the presented ranges. It is clear that, as set out, the CAPM methodology does not correctly consider the balance of evidence.
Do returns from alternative asset pricing models suggest that CAPM is pricing in all systematic risk for water companies?	Alternative asset pricing models with stronger explanatory power such as the q-factor model indicate that the Ofwat DD CAPM understates returns for water companies by 70-200bps.
Is the equity return available set at a level sufficiently above the cost of debt to reflect fundamental risk differentials?	Investors that commit capital into water companies as equity capital take on significantly more risk than debt investors in the same companies. The Ofwat DD CoE does not include sufficient risk premium relative to debt (inherently a much safer investment with stable, predictable cashflows) to persuade investors to commit equity capital – the differential in risk premium is not reflective of risk differentials.
Does the notional company have sufficient headroom on debt financeability over the long term?	Headroom for key projected coverage metrics such as AICR are projected to decline below target credit rating levels as more expensive new debt replaces cheaper embedded debt. This is driven by a CoE which is too low and corroborates that the current financial assumptions are not sustainable over the long term.

Under this framework, our assessment is that the specification of the notional company represented in the draft determination is not an investable proposition. To ensure that equity is attracted, action needs to be taken.

Specifically, this requires:

- **setting an appropriate cost of capital** as we summarise below and set out in RR01; and
- **mitigating the overall balance of risk and rewards** as we summarise below and set out in RR02.

3.4. Setting an appropriate cost of capital

The financial modelling, and data tables included in our response use Ofwat's view of the cost of capital as an input. However, as set out above, we disagree with Ofwat's view, and the approach to setting this. We therefore provide an alternative view which we believe more appropriately compensates investors for the level of risk at PR24. Table 2 below sets out our updated view of the appropriate WACC in our response to the Draft Determinations.

- This view is based on our spot estimate, which is within the range set out in KPMG reports produced for the industry at our proposed 60% notional gearing.
- It reflects an approach that is conceptually consistent with the CMA's rationale in the PR19 redeterminations. On RFR, considering yields on ILGs and AAA corporate bonds. On TMR, the analysis provides a stable estimate, updating analysis to reflect new DMS data that was not available at the time.
- It starts with the CMA's approach to beta. This is updated to reflect the inclusion of Pennon as a pure play competitor, then reflecting the potential increases in systematic risk by considering other estimates at the upper end of the range. Given that the potential impact of significant investment on systematic risk was recognised in the DD and has previously been recognised by other regulators we have selected a point estimate at the top end of the range.
- Comparing the CAPM results to other cross checks (based on historical data) suggests that it is underestimating systematic risk for the water sector. Therefore, as in the DD, to maintain investability we are applying an aiming up adjustment.
- On the cost of debt, we are recognising the likely issuances throughout the rest of this price control period and applying an adjustment to the cost of new debt reflecting recent issuances.

Table 2: Summary of updated WACC parameters (Nominal)

Parameter	Ofwat Draft Determinations	Wessex Updated View
Cost of equity	6.9%	8.4%
Cost of debt	4.9%	5.5%
WACC	5.8%	6.7%

3.5. Mitigating the overall balance of risk and rewards

The draft determination sets out that the risk and return package has been calibrated such that equity investors in an efficient company have a reasonable prospect of earning the base allowed return, while maintaining financial incentives to outperform cost and performance targets and penalties in case of underperformance. Underpinning this is RoRE analysis presenting a symmetric and balanced range of risk and reward.

However, 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, the risks need to 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 (i) on 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 below, the P50 for the notional company is negative, and far from zero.

Figure 3: Draft determination RoRE modelling results

	Notional Company		
	P10	P50	P90
Totex	-4.93%	-1.88%	1.03%
Mex & ODI	-3.68%	-1.72%	0.08%
Financing	-1.85%	-0.34%	1.19%
Revenue	-0.05%	-0.03%	0.00%
RoRE (additive)	**-10.52%**	**-3.97%**	**2.30%**

This miscalibration of expected and allowed return could be addressed by either further regulatory mitigations at source, aiming up on the cost of capital, or a combination of the two.

UK regulatory guidance indicates a preference to address risks at source where possible. Risk mitigations at source can prevent customers from remunerating companies for risks that have not occurred while sufficiently protecting investors and attracting investment.

Accordingly, we are proposing to mitigate the risks observed in the draft determinations as follows.

- Appropriate funding of base costs to deliver stretching performance levels.
- Setting performance commitment targets at a level taking account of funding and current performance.
- Automatic ex-ante indexation of retail costs.
- An uncertainty framework to fund efficient changes in enhancement costs.
- Dead bands and collars on performance commitments where there is significant exogenous risk.
- ODI incentive rates set at the level which represents the value for customers and the environment.
- Rebasing the C-Mex target on the water sector median instead of using the UKCSI average, given the median water company underperformed the UKCSI average.
- Recalibrating the allowed cost of debt for new and embedded debt consistent with the water sector's actual financing terms and forward performance expectations.
- Modified application of non-delivery and delay Price Control Deliverables to reduce regulatory discretion in application of allowance clawback for late delivery.
- Redesigning the ODI aggregate sharing mechanism (ASM) and the totex ASM to more closely reflect the features of Return Adjustment Mechanisms implemented by Ofgem. For example, adding an upper threshold on the totex ASM with enhanced sharing rates.

The table overleaf shows the impact on RoRE once these mitigations have been applied.

Figure 4: Draft determination RoRE modelling results (post mitigations)

	Notional Company		
	P10	P50	P90
Totex	-2.39%	-0.05%	1.94%
ODIs & MeX	-2.81%	0.16%	2.76%
Financing	-1.89%	0.00%	1.97%
Revenue	-0.05%	-0.03%	0.00%
RoRE (additive)	**-7.14%**	**0.09%**	**6.67%**

3.6. Financial resilience under the draft determination

In WSX-R05, we demonstrate the company's financial resilience on both a notional and actual basis; through to 2030, and in the long term. Specifically, we show that under current rating methodologies we can maintain the target credit rating (Baa1 / BBB+) under the notional structure and investment grade credit rating under our actual structure. In all our modelled scenarios, significant mitigations are required in the form of equity being attracted. Therefore, as set out in the preceding sections it is critical that the final determination is sufficiently set as to attract this equity.

3.7. Financial structures

Ofwat's draft determination includes two mechanisms aimed at incentivising outcomes in relation to company financial structures. Below we provide a summary of our response on each.

Proposals on gearing

We cannot support the proposed mechanisms in relation to levels of gearing over 70%. In our view, the capital structure of a company is the responsibility of that company's Board. Furthermore, as set out in WSX-R03 we have concerns with the specific proposals included in the draft determination.

We believe that, to the extent to which the regulator considers such a mechanism is necessary where it has concerns over financial resilience of specific companies it should apply any further mechanisms or licence changes to those companies specifically, and not at an industry level. This would provide at least some protection against the adverse outcomes outlined in our representation on this matter.

Consultation on equity listing mechanism

In general, we are supportive of the proposal to support new equity issuance. Given the scale of equity required over 2025-30 we think that it is important that all forms of equity issuance are correctly and fully incentivised. Crucial to this will be setting an equity return that appeals to investors; and other forms of incentive such as this proposal will be insufficient to correct a miscalibration of the allowed returns.

However, we note we do not support the underlying view that listed companies will perform better. Indeed, Wessex Water is an industry leading company with YTL a model long-term, committed investor.

4. Cost assessment

4.1. Base costs

Since receiving our draft determination, we have engaged constructively with Ofwat on the matter of base costs (i.e. through the company meetings and inbound query process). We appreciate this engagement, and looking to positively reflect it, our draft determination 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 also highlighted our 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 in the context of PR24. 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.

In response to our query on base costs in the draft determination, 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. We have introduced our new cost adjustment claim on this basis. This is consistent with the PR24 Methodology which sets out the following:

> *"In an exceptional case, where a company considers that the benchmarking models do not fit its specific circumstances, it can submit a cost adjustment claim and provide evidence as to why it is different. Companies will need to provide compelling supporting evidence for any cost adjustments. We will continue to have a high evidential bar. For PR24 we are providing greater clarity on our expectations and placing a greater emphasis on two sided adjustments for factors reflected in historical expenditure."; and*
>
> *"We are open to considering company evidence on additional exogenous factors / cost drivers that require a step change in efficient capital maintenance expenditure through the cost adjustment claim process."*

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 WSX-C01). However, our approach is intended to work constructively 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 the long-term.

The value of this claim is provided below. For further details on the need for this investment please see both our business plan (in particular "WSX10 - Maintaining our services commentary and analysis"); and representations on base costs ("WSX-C01 - Base costs").

Figure 5: Step up in capital maintenance / base costs (cost adjustment claim)

	WR	WN+	WWN+	BIO	Wholesale
Cost adjustment claim (£m)	11	252	118	114	**494**

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 this has put pressure on companies' expenditure. Successive price controls have increasingly underfunded companies through inconsistent formulation of the notionally efficient firm; ever-stretching performance targets that are assumed to be funded through base cost allowances via efficiency improvements; and frontier shift targets that, with hindsight, have not been realised by the water industry or the UK economy as a whole over the last 20 years.

This repeated ratcheting of companies' expenditure over successive price controls has created a cycle of underfunding, which in turn results in underinvestment (especially in relation to capital maintenance where the negative outcomes only become apparent over time) 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. However, this relies on the following key assumptions:

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

In practice, however, the complexity of assets in the water industry means that this is a difficult standard for any econometric model to achieve.

Therefore, it is important that top-down econometric modelling is seen as a useful tool and used alongside other methods (such as bottom-up approaches that can capture the detailed needs of specific assets) to arrive at a balanced view of the efficient costs required to meet the ultimate goal of funding necessary asset replacement and capital maintenance. We understand, there is no perfect econometric benchmarking model that can necessarily provide the right view of efficient base costs to fund capital maintenance and asset replacement activities, and this inherent limitation points towards it being used as one of the tools to estimate efficient costs, and not the only tool.

This is particularly relevant for Ofwat's cost benchmarking models because the above assumptions on which econometric modelling could be considered to be able to identify efficient cost allowances on its own do not hold.

Firstly, on (a), it is widely recognised (notably by the House of Lords and the National Infrastructure Commission) that the water industry has suffered from systematic underinvestment in the past, which now needs to be urgently corrected.

Furthermore, Ofwat's own assessment highlights that companies' RCV run-off rates have become disconnected from their capital maintenance / asset replacement rates.[2] While Ofwat presents this as evidence that RCV rates are too high, an alternative view is that this is evidence of a binding constraint in funding, with companies unable to meet short term targets while simultaneously fulfilling obligations to sufficiently invest in their depreciating assets.

Furthermore, the modelling period includes: (i) the financial crisis and the pandemic, where investment in infrastructure was historically low, due to the uncertainty created by the macroeconomic conditions; and (ii) a period

[2] Ofwat (Dec 2022) 'Creating tomorrow, together: Our final methodology for PR24 – Appendix 10 Aligning risk and return'; page 52

of “trough” in the lifecycle of lumpy infrastructure investment across the industry, which is driven by variation in the profile of assets held by different companies.

Together, this implies that the historical costs on which Ofwat’s costs models rely are not reflective of efficient future costs because they bake-in, and therefore perpetuate, historical underinvestment. Fixing this historical underinvestment going forward requires further consideration because we not only need to ‘course correct’, but also catch-up on shortfalls in historical capital maintenance allowances to ensure we are on a long-term sustainable path.

Secondly, the models are not well-specified, and do not reflect efficient costs for Wessex Water. The water models show the smallest companies to consistently be at the frontier, indicating that the models struggle to fully account for scale. Additionally, the models do not account for drivers of capital maintenance spend, and the retail models are unlikely to be able to adequately predict the future given that economic conditions have now diverged significantly from those that prevailed during the sample period.

Despite being limited by the above factors, Wessex has responded to incentives set by Ofwat and pushed itself to deliver for its customers. As such, it has been able to achieve high performance across outcomes while staying within its base cost allowances. However, we cannot continue delivering for our customers in the same way if we do not urgently invest in our assets.

In the context of the limitations of econometric methods, highlighted above, modelled costs included in the draft determination do not reflect Wessex Water’s (or, in our assessment, any other companies’) true efficient costs, and we cannot rely solely on them to deliver for our current and future customers. Therefore, we have undertaken a 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. We are acutely aware that customers should only pay our efficient costs. Therefore, we have market-tested and assured our bottom-up estimates with industry experts to ensure they are efficient.

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.

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. We further note this now includes investment in relation to pollutions and flooding, consistent with Ofwat’s view that this increase in activity should be funded from base.

It is important that we are allowed these costs for the provision of reliable water and wastewater services to our customers going forward – these are not currently reflected in the Draft Determination.

4.2. Enhancement costs – Overall approach

Ofwat’s overall approach to enhancement is comprised of three key approaches: (i) econometric benchmarking; (ii) deep dives; and (iii) shallow dives. We welcome Ofwat’s objective to ensure all enhancement costs represent an efficient level. We would encourage a view that accounts for the considerations we set out below.

Overall approach

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 of its requirements. Without this the approach is limited. 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.

Approach to benchmarking

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; and 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.

Deep dive assessments

We welcome Ofwat's use of enhancement-specific engineering assessments. As discussed above, many enhancement schemes are unique by design, and this makes it very difficult to reliably compare or benchmark costs between companies. In these circumstances, it is important to consider the evidence for why requested allowances are both necessary and efficient.

We submitted extensive evidence on our costs as part of our Business Plan. This included evidence on the need, scope, and efficient costs of these activities. In some areas, we do not consider that Ofwat has provided sufficient justification for the application and / or scale of efficiency challenges. Our response includes additional evidence which is aimed at addressing Ofwat's concerns before the final determination.

Shallow dives

To conduct its shallow dives, Ofwat has derived a company-specific challenge – capped at 20%. On this basis, the challenge for Wessex Water has been set at 20% (equivalent to £14 million). This represents a cut to our costs that we do not believe appropriately reflects the efficiency of our costs. This cap has been set at twice the level it was at PR19, where it was 10%, with no explanation of the appropriateness of this change in practise. We suggest that final determinations should set shallow dive efficiency challenges at the minimum of: our updated efficiency score (which we expect to be considerably below 20%); or a cap of 10%.

There is also one enhancement area where we do not consider a shallow dive should be applied – flow monitoring at STWs. This investment area accounts for more than £10 million, which is above Ofwat's threshold for a shallow dive.

4.3. Our approach to cost estimation

Ofwat's approach to assessing our enhancement costs has resulted in significant efficiency challenges across many key areas of investment. We understand and agree with the aim of ensuring efficiency, and consider our internal approach to cost estimation results in proposals that reflect the true efficient costs. To address Ofwat's concerns we provide further detail on our approach in our cost assessment representations, and a summary below.

We ensure accurate estimation of project costs, risks and timescales as a result of our internal commitments to:

- regularly assess that our internal delivery approach is getting the best value for money.
- ensure we maximise the utilisation of our internal resources.
- accurately compare a range of no-build, low-build and construction options on a whole life totex basis to ensure the best value is delivered.
- use the information to combine projects into programmes of work to deliver maximum efficiencies.

- test the effectiveness of our framework contract prices to ensure they remain competitive.

Each solution option is then reviewed technically and financially as part of our financial governance processes and the lowest whole life cost option is selected, unless there are specific circumstances where this is not feasible or appropriate. This option then proceeds to contract award and delivery as a project. Projects greater than £10m in value are approved by the Board. The financial and programme progress of each project is reviewed on a monthly basis and reported to the Board, with appropriate corrective action taken if risks materialise or third-party delays require an escalation to the executive team.

This standard process, applied to each project as business as usual, allows appropriate data to be fed into the estimation of the projects subsequently assessed for each business plan. However, further assessments of efficiency are carried out for the business plan estimates, due to the fact that solutions are normally developed for business plan purposes prior to the completion of appraisal and outline design. This design work will then commence during the price control in which the work is planned to be delivered.

For further information on our approach to costing, please see WSX-C03.

4.4. Retrospective nature of the draft determination

The draft determination introduces various additional mechanisms to "to prevent customers from paying twice". We firmly support this aim, and our plan includes no proposals which have been previously funded by our customers.

The nature of network companies, and indeed the incentive-based regulation the water sector is subject to, means that the use of simple tests or assumptions cannot be used to establish what has been funded. Indeed, we think that any analysis should reflect:

- Symmetry, such that the assessment considers and reflects areas where companies may have over-delivered in some areas.
- The implication of outcome delivery penalties, which in effect return money to customers for under-delivery.
- The nature of the totex and outcomes framework introduced at PR14, under which companies are not funded to deliver specific outputs or schemes.[3] On this basis, companies have been specifically encouraged and incentivised to consider in-period whether any cost allowances could be reallocated and used to deliver different but better outcomes at lower costs for customers as a result of reprioritisation and efficiencies.
- Consistency across all areas of the price control. The approach to assessing whether or not an enhancement area should be funded in base is directly contradictory to the approach taken in the cost assessment models. For example, in relation to assessing enhancement, Ofwat considers companies are able to make the appropriate trade-offs to prioritise their base costs for some additional activities (e.g. in relation to our proposal to significantly increase CCTV monitoring). However, in relation to base costs, Ofwat considers companies are funded to deliver a specific level of output (e.g. in relation to metering or mains replacement). It is our view that both cannot be simultaneously true.
- The wider context of systematic underfunding in the water sector historically, as set out in section 4.1 above.

There are various ways of ensuring this, suggestions are provided below.

---

3 Page 7&8, PR24-draft-determinations-Expenditure-allowances-to-upload.pdf (ofwat.gov.uk)

- Firstly, to address the **principle-based contradiction** and ensure consistency with the totex and outcomes framework, there is a greater need to consider what has been actually delivered relative to what has been funded at a high (or, price control) level (i.e. not in relation to individual assessments of specific low-level outputs). This would require greater scrutiny of what companies have delivered in the round; and acknowledgement of the trade-off's each company makes relative to its own individual circumstances to deliver efficiencies for customers.

- Secondly, to address **the contradiction in application** various changes could be made to ensure consistency. To be consistent with Ofwat's view on base costs (and specifically, the base cost adjustment claims, under which companies are funded to achieve a specific output); one option could be to increase base costs where Ofwat considers enhancement requests can be better funded by an increase in a specific output that it considers is delivered through base.

For further information on this, please see WSX-C04.

4.5. Ofwat's industry cost adjustments

Ofwat has 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 regulatory inconsistency in 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 methodologies proposed for the industry-wide cost adjustments are somewhat inconsistent. There is no overarching framework which has governed the rationale for the inclusion or exclusion of industry-cost adjustments currently proposed or for the choice of methodologies for each, which have little read-across. We encourage these observations be robustly addressed for final determination. We have a number of methodological issues with the individual claims themselves, which we detail in our individual cost assessment representations.

In terms of scope, we consider there would be merit in Ofwat applying an industry-wide claim to reflect our "step up in capital maintenance and base costs" adjustment at an industry level.

4.6. Real price effects

As set out in our business plan we do not support true-up mechanisms for RPEs during PR24. Whilst the recent substantial price increases observed (e.g. for energy and chemicals) are largely beyond our control, we do not consider our customers should bear the uncertainties of this. Neither do we support the increased regulatory burden and complexity that true-up mechanisms provide. Instead, we consider the setting of ex-ante allowances to be a more appropriate way to set efficient and sufficient allowances for PR24.

Customers are protected against variance in expenditure through the existing totex reconciliation and can further be protected by the appropriate use of forward looking RPEs. This strikes the correct balance of risk, whilst giving customers protection against price changes that are different to those expected whilst still retaining incentives for companies to manage their consumption and power and input purchasing strategies efficiently.

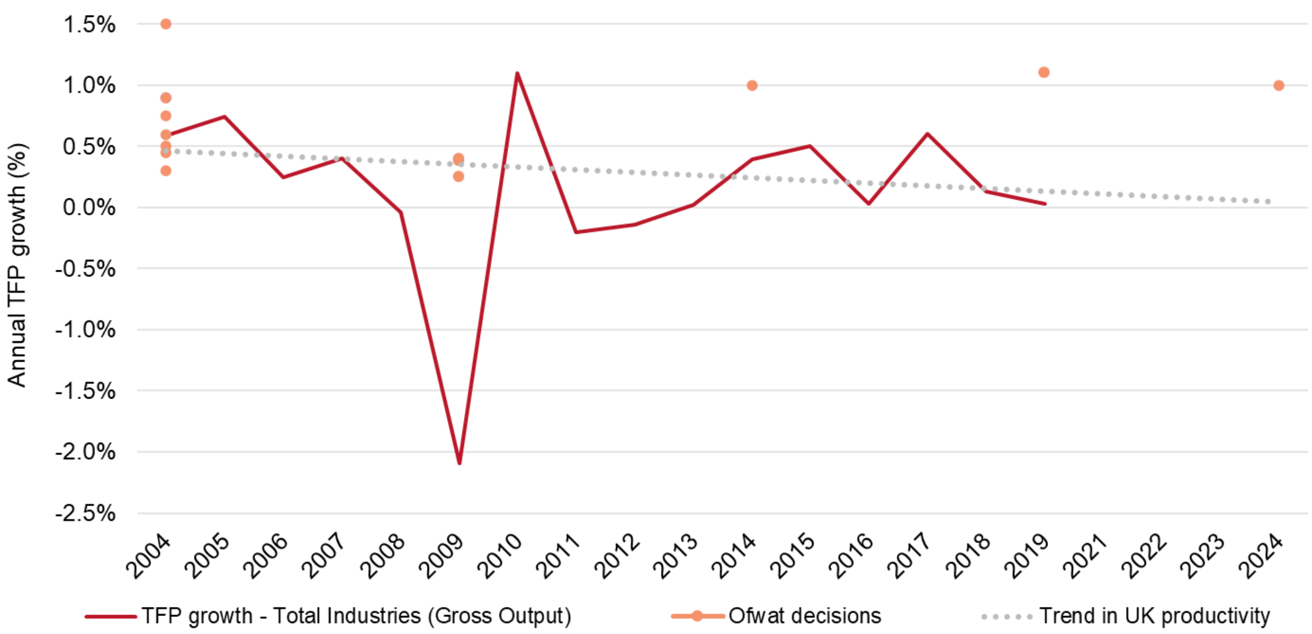
As part of our response to the industry-wide cost adjustments (WSX-C22) and RPEs (WSX-C21) for energy, the industry commissioned a study by Baringa. It is our view that (i) the use of different indices and price series has a negative impact on ex-ante base allowances that is unreasonable; (ii) the use of the Ofgem electricity day-ahead monthly baseload contract price for the FY23 RPE adjustment results in forecast energy costs that decrease markedly and rapidly which too is unreasonable; and (iii) the RPE model is not robust as the impact on allowances of the energy cost adjustment is sensitive to the base year in which the adjustment is made. We provide further detail on our energy and RPE representation more generally in WSX-C21.

Finally, we consider RPEs should apply to the relevant portion of totex, not just base or enhancement expenditure. For example, materials purchased for the maintaining of current service levels (base expenditure) are procured in the same way and subject to the same input price pressures as materials purchased for improving service levels (enhancement expenditure). We see no reason why a universal approach should not be adopted for final determination.

4.7. Frontier shift

In our business plan we proposed a stretching frontier shift (ongoing efficiency) challenge on costs of 0.5% pa (this is in line with the industry average and higher than the productivity performance of the UK as a whole). In its draft determinations, Ofwat has proposed a materially higher frontier shift challenge of 1.0% pa. This position was also informed by a report by Europe Economics (EE): 'Europe Economics' critique of Economic Insight reports on productivity and frontier shift at PR24'. The following graph provides context for this decision, by showing trends in UK productivity since 2004.

Figure 6: UK productivity growth and Ofwat frontier shift (2004 to 2024)



Note: At PR04 and PR09, Ofwat set separate frontier shift challenges for different components of costs, thus there are a range of data points for these price control determinations. Data is not yet available for the period after 2019. Source: Economic Insight Analysis of EU KLEMS and Ofwat data.

It is our view that the evidence demonstrates the frontier shift for the water industry at PR24 should be set at a substantially lower level than currently proposed by Ofwat. This is because: (i) we would expect frontier shift to be higher at times of high productivity, and lower at times of low productivity; (ii) data shows that over PR14 and PR19, the water industry delivered low productivity, in-line with the low and flat productivity performance of the UK; and (iii) the water industry is not 'high-tech', the technology sector being the main driver of UK productivity. As part of our response, we commissioned a study by Economic Insight which is included in WSX-C22.

On the basis of this, we would encourage Ofwat to further consider the evidence on frontier shift.

5. Outcomes

5.1. Introduction

In our PR24 business plan, we included a stretching yet achievable set of performance commitments. We are committed to delivering improved outcomes for customers. Together, our proposals represent an ambitious package that will deliver significant improvements for our customers and the environment across a range of outcomes. We did not propose any bespoke performance commitments, and our business plan also used Ofwat's ODI rates.[4]

Customer views were central to our proposals. We developed these over two years, during which we sought extensive customer input through a robust framework of research and engagement.

Our business plan commits to stretching our strong industry performance and improving the level of outcomes we deliver for customers and the environment.

Ofwat's draft determination includes performance levels which are, in many cases, considerably different to our own proposals. We understand Ofwat's aim to increase performance in the sector, but consider this ambition needs to be set with consideration of what is an achievable level (i.e. P50) within a given cost allowance; and with cross-checks against current performance on costs and outcomes.

We have carefully considered Ofwat's draft determination, and the performance levels we as a business can deliver under our view of the appropriate cost allowances. On that basis, we have revised our plan such that:

- We accept **Ofwat's targets** in a number of areas including: water supply interruptions; compliance risk index; mains repairs; internal sewer flooding; sewer collapses; and serious pollutions.
- We are proposing **additional stretch** compared to our business plan, on key outcomes including: leakage; per capita consumption; and storm overflows.
- We are **maintaining our business plan** proposals where we consider these represent stretching but achievable targets, and where we would need significant additional investment to meet Ofwat's targets.
- We have **updated our targets** in some areas to reflect new information, or changes in requirements since business plan submission, including: bathing water quality; and total pollution incidents.

Furthermore, we note that there are some targets which we do not believe are appropriately aligned to customer interests, for example unplanned outage; and customer contacts about water.

Our proposals are detailed in in our representation on outcomes (WSX-O01).

We are also concerned with Ofwat's proposed ODI rates, and in particular the scale and frequency of change in these. We consider these rates now sit above the value represented by the outcomes for customers and the environment.

Under our revised proposals included in this response, we estimate that Ofwat's proposals would result in us incurring net ODI penalties of around **£162 million** over 2025-30. This assumes that we are adequately funded for the investment that is needed to achieve the level of performance in our business plan. If we reflect the cuts to both

4 PR24: Using collaborative customer research to set outcome delivery incentive rates - Ofwat

base and enhancement spend that Ofwat proposes, this expected penalty would be significantly (around £90m) higher.

To address this skew, we ask Ofwat consider its approach to setting PCLs and ODI rates. Alternatively, Ofwat could explicitly recognise the impact of performance commitments on companies' overall balance of risk and return. This is discussed in more detail in representation WSX-R01.

5.2. Outcome delivery incentives (ODIs)

To incentivise the right (or efficient) level of performance, ODI rates should reflect the value of the relevant outcome to customers and the environment. There is considerable uncertainty in trying to derive this value. This uncertainty is demonstrated by the changes in Ofwat's approach between PR19 FD (2019), PR24 Final Methodology (2022), an interim publication on outcomes (2023), and the Draft Determinations (2024). The results of these various changes are indicated for Wessex Water in the table below.

Figure 7: Wessex Water ODI rates

	PR19, £m (Ofwat, FD)	PR24 BP, £m (Ofwat August, 2023)	PR24 Ofwat DD, £m	Change, PR19 to PR24 DD	Change, Ofwat BP to PR24 DD
Per capita consumption (PCC)	-0.130	-0.483	-0.252	94%	-48%
Water supply interruptions	-0.140	-0.392	-0.274	96%	-30%
Mains repairs	-0.046	-0.105	-0.092	99%	-13%
External sewer flooding	-0.800	-2.513	-3.008	276%	20%
Compliance risk index (CRI)	-0.580	-0.343	-0.440	-24%	28%
Internal sewer flooding	-5.690	-5.614	-8.099	42%	44%
Total pollution incidents	-0.270	-0.791	-1.279	374%	62%
Discharge permit compliance (DPC)	-0.530	-2.359	-4.820	810%	104%
Leakage	-0.330	-0.364	-0.909	175%	150%
Unplanned outage	-0.243	-0.700	-1.816	647%	159%
Customer contacts about water quality	-0.603	-3.458	-9.058	1402%	162%
Sewer collapse	-0.125	-0.756	-2.970	2276%	293%

As shown in the table, the results of Ofwat's changes have a significant impact on Wessex Water's ODI rates (as they do for the industry as a whole). Ofwat's DD states: *"For most companies, the rate proposed for PR24 is significantly stronger than at PR19. This reflects our overarching aim to set powerful incentives on performance."*[5]

However, there is no apparent cross check that these powerful rates represent the value of these outcomes to customers and the environment. We are concerned these rates now sit above the marginal benefit delivered for customers and the environment. That is, companies may be incentivised to deliver performance beyond that which is valued by the customer.

At PR19, our rates were set using estimates of marginal costs and marginal benefits and we believe these rates are more appropriately calibrated to the interests of customers and the environment. In some instances, this may

5 PR24-draft-determinations-Delivering-outcomes-for-customers-and-the-environment.pdf (ofwat.gov.uk), section 8.8.3.

require further consideration (e.g. in relation to new PCLs) and we would be pleased to work further with Ofwat to derive appropriate rates in these cases.

Furthermore, as set out in Chapter 3 and WSX-R02, in our view the overall risk and reward package represented in the draft determination is not balanced. In particular, the P50 is misaligned such that it represents underperformance; and there is a skew in the range of expected returns such that underperformance is much more likely than outperformance. We propose two mechanisms aimed at addressing this, at least to some extent:

- Deadbands on PCs where performance is driven by factors outside of management control, in order to better align the P50.
- Collars on all outcomes, equivalent to those introduced for new outcomes in the draft determination. This would address some of the issues relating to the overall negative skew in the package.

5.3. Measures of experience

Our views on the three measures of experience, C-MeX, D-MeX and BR-MeX are set out in WSX-O03. Here, we make constructive suggestions in relation to survey methodologies and weightings.

Our key concern is in relation to C-MeX and the use of the UKCSI as a cross-sector benchmark to calculate C-MeX under- and outperformance payments. Wessex Water offers a high level of customer service, and this is demonstrated by our leading performance on this measure during the current AMP. On this basis, we have concerns regarding the comparability of water with other industries such as retail.

The proposed methodology for translating UKCSI measures into C-MeX benchmarks is unpredictable. Outperformance payments will likely be skewed downwards, and it is likely the current level of reward for a consistently high performing water company will become unattainable. We have suggested retaining the current methodology for the first year of the AMP while water companies, Ofwat, and the Institute of Customer Service work together to produce a cross sector benchmark that will give confidence to water companies to invest further in customer experience.

6. Price control deliverables (PCDs)

6.1. Introduction

PCDs are new mechanisms, introduced at PR24. As explained in our PR24 business plan and response to Ofwat's Draft PR24 Methodology, we support PCDs where they are used to promote an outcomes-based approach and do not lead to more input/output-based measures in place of performance commitments. In this context, we have concerns with the way in which some PCDs have been set and with the framework:

- It weakens the totex and outcomes framework which was introduced to allow "*companies more flexibility to deliver customer outcomes in the most efficient way*" in that it removes this flexibility and restricts companies' abilities to make efficient trade-offs.

- The scope of the PCD framework duplicates existing mechanisms by introducing further penalties where customers are already protected from the consequences of non-delivery. There is also some duplication within Ofwat's PCD package that could lead to companies being penalised twice for non-delivery of the same outputs.

- PCDs introduce further downside skew. This is because: (i) rewards for early delivery or on-time delivery are a quarter of the penalties for late delivery; (ii) rewards are only provided once, independent of how early the project is delivered, while penalties accrue for each year of delay. For further information please see WSX-R01.

- The design of specific PCDs does not reflect the degree of uncertainty and potential for change during AMP8, and the resulting need for flexibility to pursue optimal solutions as companies' investment programmes are delivered during the AMP. This creates a risk that companies will be required to make investments that are inefficient and / or not in the interests of customers and wider society. This consideration is particularly acute for two PCDs (storm overflows and STW growth).

- Where the new Government introduces legislative change and reform, companies could face penalties for delivering those new obligations.

- The calibration of PCD payment rates may require further consideration to ensure that they result in the correct adjustment at PR29.

Unless these issues are addressed, the implementation of PCDs will create a material downside risk for companies. We have incorporated this within our RORE analysis presented in our separate representation WSX-R02 and WSX-R01.

More generally, we are concerned that the PCD framework is not sufficiently mature, and we would encourage a view that accounts for this. For example, delaying the introduction of PCDs or only introducing them for certain areas; and greater industry and company level engagement in this area. We would welcome a further discussion on this.

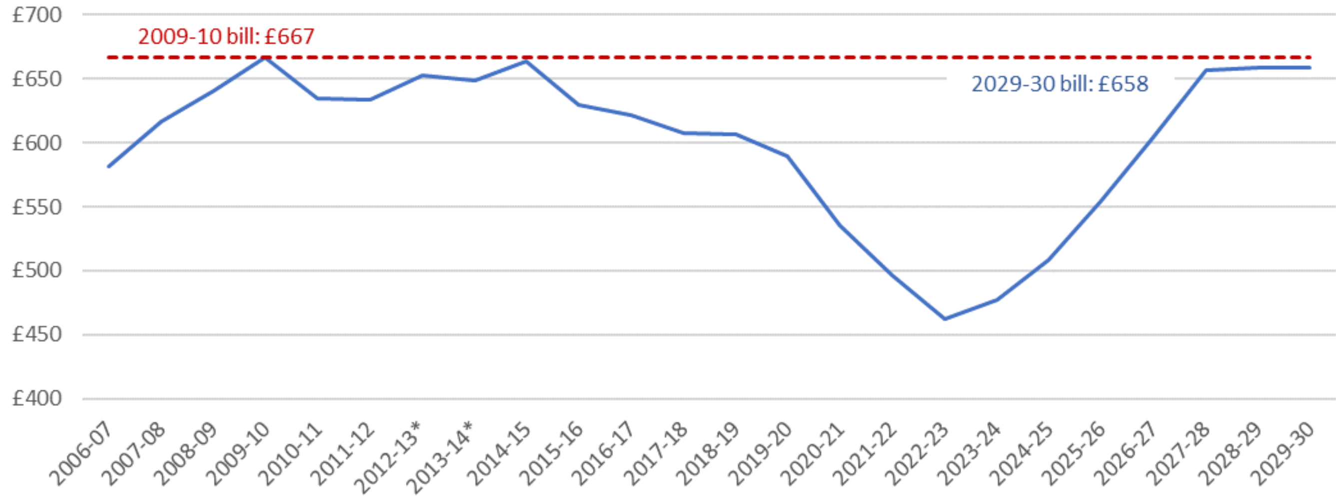
WSX-O02 sets out our proposed changes and the reasoning for these changes. We consider our proposals for an uncertainty mechanism could also help to mitigate some of the issues with Ofwat's PCD framework.

7. Bills and affordability

We, and our long-standing shareholder, are committed to delivering the investment in our plan for the benefit of our customers and the environment. To meet this commitment, we need to strike the right balance and make trade-offs between the following considerations: (a) investment; (b) deliverability; and (c) affordability.

On this basis, our revised plan proposes the bill profiles set out in chart below.

Figure 8: Real bills 2006-07 to 2029-30



It is the Board's view that our real bill increase should be less than 30%. Under this constraint our bills will remain lower than our 2009-10 bills in real terms.

As set out in our LTDS, we expect the need for investment to continue to increase over future AMPs. On this basis, we do not believe that a short-term focus on reducing bills is appropriate. Subduing revenues (and hence bills) artificially now, will perpetuate downward pressure on investment at a time where there is widespread recognition that a step change is required. However, our Board is committed to maintaining affordability in the context of this much needed investment and believes that, to strike the right balance, the real increase in bills should be less than 30%. This has also been discussed with and supported by our Customer Challenge Group.

In the context of the investment included in our plan, we have utilised some of the affordability levers in the regulatory tool kit. Specifically, we have employed the following levers, in the following priority order:

1. smoothing the revenues within period;
2. adopting the proposed RCV run off caps; and
3. considering the proportion of revenue collected from households and non-households.

Were Ofwat's view of the appropriate cost allowances to be materially lower than ours at final determination, we would expect Ofwat to unwind some of these measures to balance affordability and the need for investment in the short and long term, to the point of natural bill rises should these be lower than 30%. If there are further increases to bills (e.g. were Ofwat to increase its view of the cost of capital), then we would expect additional levers to be pulled to keep the five-year real increase in bills below 30% in the following priority order:

1. slowing down cost recovery of IRE;
2. further reductions to RCV run off rates; and
3. profiling statutory investment beyond 2030.

However, it is important to note, we would not consider it appropriate to apply any of the levers set out above at the expense of debt financeability. Instead, if there was fundamental pressure on credit metrics, we would consider further bill rises.

We remain fully committed to eliminating water poverty by 2030

We understand that bill rises do not impact all customers equally and are fully committed to eliminating water poverty by 2030. We are proposing to do this by:

- expanding our social tariff offering, funded entirely by our increased cross subsidy willingness to pay;
- trialling innovative tariffs to give customers options and incentives to reduce bills; and
- being involved with industry and policy initiatives to better measure, understand and impact those in water poverty.

We encourage Ofwat to consider our affordability measures in the context of our plan, and its view of the appropriate cost allowances.

As set out above, should natural bill rises be less than 30% at final determination, we would expect Ofwat to unwind these levers such that the increase once again becomes 29%. Should they be higher than 30%, we would expect Ofwat to apply the levers set out above in the priority order provided to keep bill rises below 30% and ensure the appropriate level of investment to meet our Board’s commitment and views on this matter. This would put our final determination more in line with the industry average when compared to the draft determination.

8. Uncertainty framework

At AMP8, water companies are facing an unprecedented increase in uncertainty (e.g. in relation to legislation on PFAS, or biosolids disposal). We have considered how the current framework could be updated to reflect these uncertainties and protect customers. As a result, we recommend that Ofwat introduce two types of uncertainty mechanism, with the design largely dependent on whether the efficient costs of the investment can be revealed as part of the PR24 process, or not.

Our proposals are detailed in WSX-M07. We note these proposals were shared with Ofwat previously, and we were encouraged to include them in our draft determination response. We would welcome the opportunity to discuss these further.

9. Long term delivery strategy (LTDS)

Last October, we published our Long-term Delivery Strategy (LTDS). The LTDS sets out how we intend to achieve the longer-term ambitions in our Strategic Direction Statement (SDS), based on adaptive planning principles; and how our PR24 business plan puts us on the path to achieving these ambitions. It supports our PR24 business plan and sets this plan in the context of our 25-year strategy to achieve our SDS aims and objectives.

Our response to the draft determination included a revised LTDS which takes account of:

- Ofwat's final guidance on long term delivery strategies issued in April 2022 ('the Ofwat guidance').
- Feedback from Ofwat on our emerging strategy in spring 2023.
- Further specific feedback from Ofwat following our business plan submission.
- Revisions to our Water Resources Management Plan (WRMP), another long-term strategic planning framework which fully aligns with our revised LTDS.

While our overarching strategy has not significantly changed, we have made some updates to clarify certain aspects and ensure that we are clearly presenting a single core pathway. We have refined our set of alternative pathways which capture the future uncertainties, as well as identifying the circumstances (or 'trigger points') in which we may need to pivot to alternative pathways. We have also made some changes to the adaptive pathways and trigger points to reflect developments since last October, e.g. in respect of PFAS and bioresources.

Our updated LTDS fully aligns with the changes made to our PR24 business plan and reflects these more recent developments in the industry.

Our Board are clear that our LTDS is an important plan that complements our SDS setting a long-term vision of how our company will sustain resilient services that deliver for customers and the environment in the long term. This has been overseen and quality assured by an independent expert who has also provided independent assurance to our Board. We have also engaged with the Chair and members of our Customer Challenge Group on our LTDS revision.

10. Process and engagement

We acknowledge that the PR24 process has been challenging. Our key areas of concern include the consultation timeframe, the volume and timing of information, the introduction of new mechanisms and policy, contextual uncertainty, document structure, and the query process. In that vein, we propose the following constructive solutions:

- **Investor engagement.** Increased engagement with wider investment community to explore more fully the implications of the draft determinations on investment, and the potential options for improvement. This could be facilitated by Water UK.
- **Company engagement.** Increased level of engagement with companies to work with us constructively to reach a final determination that is acceptable for all key stakeholders.
- **Flexibility.** Consider introducing an autumn stage in the PR24 process to review new and additional information, particularly in areas of enhancement expenditure, Outcome Delivery Incentives (ODIs), and Price Control Deliverables.
- **Process extension.** We support Ofwat's proposal to allow for final determinations to be published by 31 January 2025 to ensure the process allows for a full and proper review of the responses to draft determinations and for further engagement in the meantime.

We believe these suggestions could lead to a more robust and effective PR24 process, benefiting all stakeholders involved.

11. Quality and Ambition Assessment

11.1. Introduction

An 'inadequate' rating in the quality and ambition assessment (QAA) does not recognise the quality or ambition of our business plan. Whilst we disagree with this assessment, we have addressed each of the concerns fully. This section sets out how we have met the six conditions Ofwat has set for us to move out of that category.

11.2. Conditions for improvement

Ofwat has set six conditions for Wessex Water to improve its plan ahead of final determinations. These are set out in the following table, alongside our approach to meeting each. We consider we have met each condition fully. Our representation on the QAA (WSX-M05) sets out how we have addressed all Ofwat's specific concerns.

Figure 9: Ofwat QAA conditions

Ofwat condition	How our response meets this condition
The company should provide Board assurance that its plan is deliverable. If the company considers that it requires a delivery mechanism to make its plan deliverable, it should propose a mechanism alongside a delivery action plan and a commitment to accept increased monitoring on its delivery plan and delivery action plan.	This assurance is provided in the Board Assurance statement that accompanies our response (WSX-A01). This is supported by a statement from our independent technical assurer Mott MacDonald. Our plan is compliant with all statutory requirements to 2030.
The company should accept our approach to the draft determination allowed return, or provide compelling evidence for an alternative approach.	Our revised data tables use Ofwat's view of the allowed return as set out in the draft determination. At this level, our Business Plan is financeable under the traditional credit metrics that Ofwat uses for financeability. This is only the case after applying mitigations, including an equity injection which is required under both the notional and actual structure. However, we consider that the view of the appropriate return will be insufficient to attract the necessary equity financing. We therefore set out an 'alternative return' in WSX-R01, which we believe would be sufficient to attract equity.
The company should provide additional Board assurance, supported by a financial resilience plan and investor support, where appropriate, to demonstrate how it will maintain financial resilience in the control period and beyond in the context of our draft determinations.	This assurance is provided in the Board Assurance statement that accompanies our response (WSX-A01). Our financial resilience plan and supporting analysis is provided in WSX-R05.

<table>
<tr><th>Ofwat condition</th><th>How our response meets this condition</th></tr>
<tr><td>The company should submit an updated long-term delivery strategy (LTDS) consistent with our guidelines.</td><td>We have updated our LTDS. Our revision of this document has been overseen and quality assured by an independent expert who has also provided independent assurance to our Board. We have taken full account of:

• Ofwat's final guidance on long term delivery strategies issued in April 2022 ('the Ofwat guidance').
• Feedback from Ofwat on our emerging strategy in spring 2023.
• Further specific feedback from Ofwat following our business plan submission.
• Revisions to our Water Resources Management Plan (WRMP), another long-term strategic planning framework which fully aligns with our revised LTDS.

Our updated LTDS fully aligns with the changes made to our PR24 business plan, and reflects these and more recent developments in the industry.

Our Board are clear that our LTDS is an important plan that complements our Strategic Direction Statement, setting a long-term vision of how our company will sustain resilient services that deliver for customers and the environment in the long term. We have also engaged with the Chair and members of our Customer Challenge Group on our LTDS revision who have been able to comment.</td></tr>
<tr><td>The company should review the drivers for its cost gap (across base and enhancement expenditure) and determine what is causing inefficiencies or reasons for company specific factors. It should revisit the scale and efficiency of its cost requests or provide significantly improved evidence to demonstrate why the cost requests are needed, efficient and reasonable.</td><td>Since submitting our plan, we have considered new information (including clarity on requirements from regulators, the input of several independent external experts, and other companies). In some areas, we have partially or fully closed the gap between the Company's view and Ofwat's view of efficient costs by applying further challenge to areas of new investment (e.g. to our nutrients programme); and to our capital maintenance programme – reducing our cost request by more than £500 million. In other areas, we provide additional evidence to support a variance to Ofwat's models.</td></tr>
<tr><td>The company should propose improved levels of stretch from enhancement expenditure in relation to meeting government targets for water companies, in particular around leakage and per capita consumption.</td><td>Having reviewed the leakage reduction ambition of other companies awarded 'standard' or higher in the QAA (see Appendix 1), we have a proposed a new leakage reduction profile that is at least as stretching as these companies. The new profile proposed in our response achieves 19.8% 3-year average leakage reduction from our 2019/20 baseline compared to 16.6% in our original submission. We have also challenged ourselves to deliver this stretch for the cost set out in our original business plan.

Our combined demand management strategy will place us on a trajectory to achieve a 21.1% reduction in distribution input by 2037/38. This includes an absolute PCC reduction of 7.6l/p/d over AMP8. We are planning to exceed the EIP and Plan for water PCC targets in 2038 and 2050.

Our proposed approach in the business plan regarding demand reductions, when combined with other supply-side options, meets the Water Resources Management Plan (WRMP) requirements to deliver a secure supply of water to customers, meet the national statutory long-term targets for demand (distribution input) reduction, and in achieving this, importantly meets the requirement to reduce abstraction from sensitive environments.</td></tr>
</table>